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No. 317.

IN THE

SUPREME COURT OF THE UNITED STATES,
OCTOBER TERM, A. D. 1922.

FRANK G. GARDNER, as Trustee in Bankruptcy of the O'GARA
COAL COMPANY,

Petitioner.

vs.

CHICAGO TITLE AND TRUST COMPANY, as Receiver of the
LaSalle Street Trust and Savings Bank,

Respondent.

CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE SEVENTH CIRCUIT.

Reply Brief and Argument for Petitioner.

HENRY M. WOLF,
A. F. REICHMANN,
ARTHUR M. COX,

Counsel for Petitioner.



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CHICAGO TITLE AND TRUST COMPANY, as Receiver of the
LaSalle Street Trust and Savings Bank,

Respondent.

Certiorari to the United States Circuit Court of Appeals for the
Seventh Circuit.

REPLY BRIEF AND ARGUMENT FOR PETITIONER.

I.

THE RELATION OF THE DEPOSITORY TO THE TRUSTEES WAS NOT
SUBMITTED TO AND DECIDED BY THE CIRCUIT COURT OF COOK
COUNTY, ILLINOIS.

THIS MATTER HAS NOT BECOME RES ADJUDICATA.

THE TRUSTEE IN BANKRUTCY IS NOT ESTOPPED FROM CLAIMING
HIS RIGHT OF SET-OFF HEREIN.

In the respondent's brief it is said (p. 8) that the relation of the depository to the trustee is not a fiduciary one, but is simply that of debtor and creditor, *and that this*

point was submitted to and decided by the Circuit Court of Cook County when it passed on the petition of the Trustees in Bankruptcy for the allowance of a preferred claim against the insolvent bank; and it is further contended that "it allowed the claim as a general claim."

Upon this premise counsel for the respondent argues that the State Circuit Court has already held, (a) that these deposits by Trustees in Bankruptcy in the designated Depository created simply the relation of debtor and creditor; (b) that the Circuit Court of Cook County, Illinois, has so adjudged in the proceedings for the administration of the estate of the insolvent depository; (c) that the petitioner herein, as Trustee in Bankruptcy, is estopped from claiming any rights in this proceeding because the predecessor trustees filed a claim in the receivership proceedings in the Circuit Court of Cook County, Illinois, and because it was allowed as a general claim. These contentions we now propose to answer.

It appears from the record herein that on June 5, 1916, the Trustees in Bankruptcy filed in the Circuit Court of Cook County, Illinois, a petition alleging deposits by the trustees, in the La Salle Street Trust and Savings Bank, prior to its suspension, amounting to \$19,843.62 and praying the Circuit Court to allow in favor of said trustees and against the La Salle Street Trust and Savings Bank *a preferred claim to the amount of \$19,843.62 and to adjudge that it was entitled to priority of payment out of the assets in the possession of the respondent as receiver, in advance of the general unsecured creditors.* (Rec., 6, 7.)

On June 30, 1916, William C. Niblack became the sole Trustee in Bankruptcy of the bankrupt estate, and continued to act as such up to the time of his death, on the 6th day of June, 1920. (Rec., 4.)

In August, 1916, the petition for priority and preference of payment of the trustee's claim out of the assets of the insolvent depository was abandoned by said William C. Niblack, Trustee in Bankruptey, so far as it prayed for the allowance of a *preferred* claim, and the claim was thereupon allowed as a general claim. (Rec., 7.)

The statement in the respondent's brief that this point (the relation of a depository to the trustees of a bankrupt estate, etc.), was submitted to and decided by the Circuit Court of Cook County when it passed upon the petition of the Trustees in Bankruptey for the allowance of a preferred claim against the insolvent bank is not justified by anything in the record, and is incorrect.

It appears from the record in this case that after William C. Niblack became sole Trustee in Bankruptey of the bankrupt estate of the O'Gara Coal Company he *abandoned the claim for preference* and permitted it to be allowed as a general claim. There is nothing in the record to show that any question was submitted to or decided by the Circuit Court of Cook County, or that there was any hearing upon the claim of any character at the time the *pro forma* order was entered allowing it as a general claim.

The first question that arises is, could William C. Niblack, as Trustee in Bankruptey of the O'Gara Coal Company, by abandoning the petition for preference and priority of payment out of the assets of the insolvent depository in the Circuit Court of Cook County, Illinois, *create an estoppel in favor of himself as receiver of the insolvent depository?*

As pointed out by the respondent's counsel in his brief (p. 22),

"William C. Niblack occupied a dual position, being not only the receiver of the bank, but being also a trustee of the bankrupt estate. It is plain, therefore,

that the bankrupt estate would not in any event be in a position to claim any advantage from an act of Niblack as receiver which it would not have if he had not performed that act. In other words, Niblack as trustee of the bankrupt estate was not in a position to assert any right against the creditors of the Trust and Savings Bank because of an act performed by him as receiver of the bank."

And again, counsel says in his brief (p. 24) :

"We venture to assert that law libraries may be searched in vain for a precedent authorizing one who happens to be a trustee of two distinct estates to take a voluntary step by which one estate is given, as against the other estate, a right which, but for such step, it would not possess."

In the face of these statements by counsel for the respondent in his brief, we are unable to understand how he can argue that the trustee of this bankrupt estate is estopped from claiming any right of set-off because William C. Niblack, *while acting as sole trustee of the bankrupt estate*, abandoned a petition which had theretofore been filed by the Trustees in Bankruptcy claiming priority in preference, and permitted his claim to be allowed as a general claim against the insolvent estate of the depository.

Counsel's argument that William C. Niblack as trustee cannot take advantage of the acts of William C. Niblack as receiver as the basis for a claim of estoppel against the Receiver necessarily admits the converse that William C. Niblack as Receiver cannot take advantage of the acts of William C. Niblack as Trustee as the basis for a claim of an estoppel.

This court will, we think, assume from the record in this case that the decisions of the state courts in Illinois would not have warranted the Circuit Court of Cook County, Illinois, in granting a preference or priority to

he claim filed by the Trustees in Bankruptcy of the O'Gara Coal Company. The Circuit Court of Cook County, Illinois, in administering the assets of an insolvent bank organized under state law, might feel itself justified in refusing a preference to a claim of this character because of the absence of any provision in the State Banking Act authorizing it, or because of the doctrine as to trust funds laid down by the Illinois Supreme Court.

It does not follow, by any means, that because the Circuit Court of Cook County, in the administration of an insolvent bank organized under State Banking Act in Illinois, did not feel justified in granting a preference and priority to the trustees on their claim, that the Federal Court, when it acquired jurisdiction of the matter upon a claim filed by the receiver of the insolvent depository, would find itself handicapped either by the State Banking Law or by the decisions of the state courts as to the trust fund doctrine. *Swift vs. Texaco*

It appears from the record that a year after William C. Niblack as trustee had abandoned his claim for priority of preference in the receivership proceedings in the Circuit Court of Cook County, that William C. Niblack as receiver of the insolvent depository came into the District Court of the United States and filed (on August 21, 1917), an amended proof of claim. We have a situation in which the insolvent depository happens to be a state bank organized under state law, and when it becomes insolvent is administered by a state court, in accordance with the provisions of the State Banking Law and the decisions of the State Supreme Court. But this bank has seen fit to accept an appointment as a *Federal Depository*. It has voluntarily assumed to act as a depository of court funds committed to its care by a *Federal court*. This appointment is provided for by an *Act of Congress of the United States*, and is

entirely outside of any provision of the State Banking Law. We submit that if a state bank is to be permitted to act as a federal depository, or as a depository of court funds committed to its care by a Federal Court, it must and does accept the appointment *cum onere*.

It accepts the appointment with all the responsibilities and liabilities that a national bank would have if it was appointed depository. It cannot be possible that Congress contemplated there should be any different kind of liability of a depository of court funds of a *Federal Court* if the depository was a national bank than if the depository happens to be a state bank.

Therefore, at the threshold, the question arises whether the Federal Court which has entrusted to the Depository court funds which are *in custodia legis* deposited in the duly designated Depository by its own court officer, is obliged to stand by with its hands tied by decisions of a state court administering the assets of the depository under state law.

. When a Federal Court is dealing with its own depository, and is considering whether or not funds *in custodia legis* deposited in a duly designated depository are to be treated as trust funds, or whether such deposits merely create the relation of debtor and creditor, surely the Federal Court is not to consider its hands tied by any state statute or rule of the state courts. The Federal Court will, we think, without any hesitation, determine that question for itself. No court could preserve its self-respect and at the same time delegate to another court having a different jurisdiction and governed by different rules the authority to determine the relations between that court and its own fiduciary or depository of funds entrusted to it by the court itself. Clearly, these are matters for the Federal Court itself to determine, and regardless of any acts that William C. Niblack, as trustee,

may have done in applying to a state court for the return of funds paid to him or his predecessors as Trustees in Bankruptcy by the District Court of the United States, we feel quite strongly that he could not under any circumstances create an estoppel either against himself or the bankrupt estate, or the United States District Court.

It appears from an examination of the decisions that the Illinois rule adopted by the state courts in Illinois, as to the right to follow trust funds, is different from the Federal rule as announced by the different Federal courts, including this court. The Federal rule as laid down in a number of cases is that if a fiduciary commingles a trust fund with his own private funds, and then becomes insolvent, the right of the *cestui que* trust to follow the trust funds is not thereby destroyed, but the *cestui que* trust is entitled to a lien or charge upon the common fund superior to that of general creditors of the trustee. The commingling being wrong, the entire fund is impressed with the trust, and as long as an amount equal to the trust fund remains in a commingled mass, the same and all of it will be made to respond to the claim of the *cestui que* trust.

Board of Commissioners v. Strawn, 157 F. R. 49.

Mercantile Trust Co. v. St. Louis & S. F. R. Co.,
99 F. R. 485.

American Can Company v. Williams, 176 F. R.
616; affirmed in 178 Fed. Rep. 420.

In *Board of Commissioners v. Strawn*, 157 Fed. Rep. 49 (C. C. A., 6th Cir. 1907), opinion by Judge Lurton, a county treasurer in Ohio deposited taxes collected by him as a general deposit in a bank. The statutes of Ohio do not permit such a deposit. It was held that the bank can acquire no title to money so deposited as against the county, nor can estoppel arise from any act of its officers which will prevent recovery of such money from the

receiver of the bank if it can be identified or traced into other property where it has been mixed with the funds of the bank.

In that case Judge Lurton said:

"The mere fact that this tax fund, which, for short, we shall call the 'trust fund' has been blended with the moneys of the bank does not fasten a lien upon the balance which the bank had on hand when its doors were closed. If trust moneys be wrongfully invested in bonds or stocks or realty, or promissory notes or bills, and the particular property into which the trust fund has been changed can be ascertained, the owner may take the property and ratify the investment. Or, if the trust funds, along with the property of the trustee or bailee, be invested in an ascertained property, equity will follow the trust fund, not by taking the entire property, for that would be unjust, but by fastening a charge upon the property to the extent of the trust fund therein discovered. The blending of the trust money with the money of the trustee was suffered at one time to defeat the owner's title and compel him to stand as a mere unsecured creditor. This was upon the idea that money was not earmarked, and, therefore, could not be recovered *in specie*. But the latter cases have met this difficulty in the ease of blended moneys in a bank account, from which there have been drawings from time to time, by the fiction that the sums thus drawn out were from the moneys which the tortfeasor had a right to expend in his own business, and that the balance which remained included the trust fund which he had no right to use. It was upon this fiction that *Knochball v. Hallett*, 13 Ch. Div. 696, 726, *et seq.*, was decided. That case was approved in *National Bank v. Insurance Company*, 104 U. S. 54, 26 L. Ed. 693, and has been followed in many subsequent cases when the trust fund has consisted of moneys on deposit. *Smith v. Mottley*, 150 Fed. 266."

In *Mercantile Trust Co. v. St. Louis & S. F. Ry. Co.*, 99 Fed. Rep. 485 (Cir. Ct., E. Dist. Mo. 1900), Adams District Judge, said:

"It is now the settled doctrine that commingling

a trust fund with the private funds of the trustee does not destroy the right of the *cestui que* trust to follow it. The commingling being wrong, the entire fund is impressed with the trust; and, as long as an amount equal to the trust fund remains in the commingled mass, the same, and all of it, to the extent of the trust fund, will be made to respond to the claim of the *cestui que* trust. This last mentioned rule is in perfect correspondence with the rule first announced, requiring the *cestui que* trust to show that his money or property is in the hands of the trustee. It simply enlarges the rule, and allows recovery when and so far as the commingled fund in which the trust fund has been inextricably confused is found in the hands of the trustee. The foregoing propositions, I believe to be fully supported by the authorities, and they are well set forth in the able opinion of Judge Phillips in the case of *Metropolitan Nat. Bank of Kansas City v. Campbell Commission Co.* (C. C.), 77 Fed. 705."

In *American Can Co. v. Williams*, 176 Fed. 816 (Cir. Ct. N. Y., 1908), Hazel, District Judge, said:

"It appears that the Fredonia National Bank, while insolvent, diverted and misappropriated the proceeds of certain sight drafts drawn by the plaintiff between May 17, 1905, and June 14, 1905, upon the United States Canning Company and the Fredonia Preserving Company which had been sent to the bank for collection and remittance. The plaintiff bases its right to recover the amount of the drafts on the claim that the bank mixed or blended the proceeds thereof with its own funds, and that therefore a trust was impressed upon the assets which came into the possession of the receiver. Such assets are insufficient to pay the creditors in full, though they were larger than the aggregate amount appropriated by the bank. Debtor and creditor relations between plaintiff and the insolvent bank did not exist and admittedly their relations were distinctly of a fiduciary character, that of a *cestui que* trust and trustee. There is no dispute over the proposition that the assets of the bank in the possession of the receiver are subject to an equitable lien in plaintiff's

favor to the extent that such assets have been augmented by the wrongful act of the bank. But the defendant contends that there can be no preferential payment unless the receiver has in his possession property or funds into which the amount of the drafts can with reasonable certainty be traced or which in their entirety or in part constitute the proceeds thereof. Before discussing the stipulated facts it probably would not be inappropriate to first state the general rule applicable to fastening special trusts upon receivers of insolvent banking institutions. The great weight of authorities as shown by the decisions of the Federal courts which, if there is any conflict of decision, this court is obliged to follow is that trust funds that have been fraudulently diverted or appropriated can be recovered of a receiver whenever such funds are susceptible of identification in the hands of the possessor, and if the trust funds have been intermingled with other property or money rendering it undistinguishable without fault of the trustee a court of equity is powerless to grant relief. But to this rule there are well-recognized exceptions and modifications, and hence, where it is shown that the unlawful appropriation of trust funds resulted in swelling or increasing the general assets of the insolvent then, even though there was such intermingling of the trust funds with the general funds as to render their identity impossible, a court of equity will decree priority of payment to the *cestui que* trust over the common creditors. That a trust is impressed upon the general mass by reason of the confusion resulting from mingling therewith the converted fund was first authoritatively decided in *Frelinghuysen v. Nugent* (C. C.), 36 Fed. 239, where the rule is stated as follows:

Formerly the equitable right of following misappropriated money or other property into the hands of the parties receiving it, depended upon the ability of identifying it; the equity attaching only to the property misappropriated. This right was first extended to the proceeds of the property, namely, to that which was procured in place of it by exchange, purchase, or sale. But if it became confused with other property of the same

kind, so as not to be distinguishable, without any fault on the part of the possessor, the equity was lost. Finally, however, it has been held as the better doctrine that confusion does not destroy the equity entirely, but converts it into a charge upon the entire mass, giving to the party injured by the unlawful diversion a priority of right over the other creditors of the possessor. This is as far as the rule has been carried.'

This doctrine was expressly approved by the Supreme Court in *Peters v. Bain*, 133 U. S. 670, 10 Sup. Ct. 354, 33 L. Ed. 696, and the same equitable principle was applied in *National Bank v. Insurance Company*, 104 U. S. 54, 26 L. Ed. 693. And such important extension from the former English rule was logically and comprehensively stated by the Circuit Court of Appeals for the Ninth Circuit in *Spokane County v. First National Bank of Spokane*, 68 Fed. 979, 16 C. C. A. 81."

The latter case was affirmed by the Circuit Court of Appeals, 178 F. R. 421.

This is also the doctrine of the English courts, in *In re Richards*, 45 Ch. D. 589, 59 L. J. Ch. 728, 63 L. T. Rep., N. S., 451;

In re Hallett, 13 Ch. D. 696, 49 L. J. Ch. 415, 42 L. T. Rep., N. S., 421. This latter case, *Knochball v. Hallett*, *in re Hallett's estate*, 13 Ch. D. 696, was cited with approval by this court in *Central National Bank v. Insurance Company*, 104 U. S. 54, at 68. In this latter case this Court said:

"The Master of the rolls, Sir George Jessel, showed that the modern doctrine of equity as regards property disposed of by persons in a fiduciary position is that, whether the disposition be rightful or wrongful, the beneficial owner is entitled to the proceeds, whatever be their form, provided only he can identify them. If they cannot be identified by reason of the trust money being mingled with that of the trustee, then the *cestui que* trust is entitled to a charge upon the new investment to the extent of

the trust money traceable into it; that there is no distinction between an express trustee and an agent or bailee, or collector of rents, or anybody else, in a fiduciary position."

The court cited with approval the rule of Vice-Chancellor Wood that

"If a man mixes trust funds with his own the whole will be treated as the trust property, except so far as he may be able to distinguish what is his own."

In this case Mr. Justice Mathews also said:

"The whole subject of this discussion was very elaborately and with much learning reviewed by the Court of Appeal in England, in the very recent case of *Knochball v. Hallett, in re Hallett's Estate*, 13 Ch. D. 696. It was there decided that if money held by a person in fiduciary character, though not as trustee, has been paid by him to his account at his banker's the person for whom he held the money can follow it, and has a charge on the balance in the banker's hands, although it was mixed with his own moneys; and in that particular the court overruled the opinion in *Ex parte Dale & Co.*, supra. It was also held that the rule in Clayton's Case (1 Mer. 572), attributing the first drawings out to the first payments in, does not apply; and that the drawer must be taken to have drawn out his own money in preference to the trust money and in that particular *Pennell v. Deffel* was not followed."

In the case now before this court for consideration there has been no transfer of the trust funds to a third person, in fact, there are no complications of any kind. The LaSalle Street Trust and Savings Bank was the depository, and is therefore the fiduciary or trustee. Most of the cases in the reports deal with a situation in which the trustee deposits funds of the trust estate in a bank account together with his own funds. In this case, however, the LaSalle Street Trust and Savings Bank *was itself the depository, and is therefore the*

fiduciary or trustee which received the trust funds of bankrupt estates and wrongfully mingled them with its own property or assets. As to commercial depositors, the title to the moneys deposited passed to the bank and it became a mere debtor to the depositor, but as to trust funds, the bank did not acquire the title and if it mingled these trust funds with its other assets the trust estates are entitled to a lien or charge upon the common fund or property prior to the rights of the general creditors. This is the holding of the decisions, and when applied to the case at bar, means that the trustees of the bankrupt estates are entitled to a prior claim against all of the assets of the bankrupt depository.

THE POSITION OF THE BANK AS A SECURED CREDITOR IS NOT DIFFERENT FROM THAT OF AN UNSECURED CREDITOR.

The claim filed by the receiver was originally filed as an unsecured claim. (Rec. p. 7). Three years after the claim was filed on August 21, 1917, the receiver filed an amended proof of secured claim. We are unable to appreciate how it could make any possible difference in the situation presented to this court whether the bank's claim was secured or unsecured. The fact remains that the bank, through its receiver, filed a claim in the District Court, and when it did so it submitted itself to the jurisdiction of the District Court to enter such order as it might deem proper.

The District Court acquired full and complete jurisdiction of the person of the receiver when, on September 11, 1914, he first filed his proof of unsecured claim. This jurisdiction of the person having once attached, was not, nor could it be, impaired in any manner, and the fact that the receiver subsequently filed an amended proof of secured claim does not in any manner impair the juris-

diction of the District Court over the person of the receiver or over the subject matter.

We are unable to see any relevancy of materiality in the argument advanced by counsel for the respondent based on the fact that the bank's claim was a secured claim.

THE APPLICATION OF THE MAXIMS "HE WHO SEEKS EQUITY SHOULD DO EQUITY" AND "HE WHO COMES INTO EQUITY SHOULD HAVE CLEAN HANDS."

Counsel for the respondent claims that these maxims have no application in the present case. His reasoning, however, is not convincing. As we understand counsel's argument, it is that the receiver of the bank need not have filed a claim in the bankruptcy court. If this be conceded, the fact remains that the receiver did file first an unsecured claim and then a secured claim, and thereby invoked the aid of the bankruptcy court to pay the whole or such part of his claim as might be required after he had exhausted his collateral security. Counsel for the respondent seems to think that the motive and purpose for which the receiver came into the District Court has some bearing upon this question. We do not agree with that contention. Having acquired jurisdiction of the person of the receiver, it was for *the court* to determine, without regard to the motives of the receiver in invoking its aid, what relief should ultimately be granted.

The whole foundation of the Bankruptcy Act in its aspect in relation to the administration of estates for the benefit of creditors is the equitable maxim "Equality is equity." Every provision in the Bankruptcy Act, from beginning to end, has for its purpose just two things,—(a) The equal distribution of the assets of a

bankrupt estate among his creditors, and, (b) The discharge of the bankrupt from further liability. There is nothing else in the Bankruptcy Act, from one end to the other except provisions designed to effectuate these two objects. Therefore, when a creditor becomes a claimant of a bankrupt estate, and files his claim in the Bankruptcy Court, and obtains an equal share of the estate of the bankrupt, he is getting it as the result of the fundamental principle and purpose of the Bankruptcy Act, which is to secure an equal distribution of the estate among creditors.

At common law, the creditors of an insolvent debtor did not participate equally. The race was to the swift. The sheriff who held an execution was not concerned about the claim of any one except the plaintiff in the execution. His duty was to levy on the assets to an amount sufficient to satisfy the plaintiff's claim in full, without regard to what effect it might have on the other creditors of the insolvent.

At common law no machinery existed for the *equal* distribution of the estates of insolvents among their creditors until courts of equity began to apply the equitable maxim "Equality is equity," and through the instrumentality of a receiver, accomplished a fair and equitable distribution of the assets of the insolvent.

When bankruptcy acts were enacted they immediately adopted this foundation principle in the distribution of bankrupt estates, and bankruptcy courts are in reality courts of equity administering the estates according to equitable principles, and therefore, the creditor who invokes the aid of the bankruptcy court by filing a claim is getting the benefit of that equitable principle which is the foundation of the act.

The receiver of the insolvent depository therefore,

when he filed a claim in the Bankruptcy Court and asked to be permitted to participate *equally* in the assets of the bankrupt estate, was applying to a court administered upon *equitable principles* and obtaining the benefit of *equitable rights* and remedies which he would not have had at common law.

We are unable to see any merit in the contention of respondent's counsel that because the claim was filed by Niblack as receiver instead of by the insolvent depository itself, that the court could not deal with the receiver as the representative of the insolvent depository.

When a receiver goes into a court other than the one appointing him, and invokes its aid for any purpose, he submits to the jurisdiction of *that* court, and that court has just as much right to deal with him and with the subject matter of his claim as though he was not a receiver. Indeed, it could not deal with him on any other basis.

Counsel's argument that

"The creditors of both concerns are equally innocent victims and there would seem to be no justification in favoring one set of their creditors at the expense of the other"

ignores every principle of law and equity applicable to a situation of this kind.

If these deposits, made by the trustees in bankruptcy in the depository, were *trust funds* and did not create the relation of debtor and creditor, the creditors of the insolvent bank have no more right or claim to them than if they were deposited in another bank. They are not part of the assets of the bank, but are a separate fund, the title to which was not in the bank and could not pass to the receiver or the creditors. The fact that the creditors of the bank may be innocent does not justify a court in giving them trust funds which never

belonged to the bank. Their rights are not in any manner diminished or impaired by giving those trust funds to the trust estate to which they belong instead of to a set of creditors of the bank to whom they never belonged.

We are unable to appreciate anything unjust or unfair in doing so.

On the other hand, to take these trust funds from the trust estates to which they rightfully belong and give them to commercial depositors of the bank, or its general creditors, (in the words of Mr. Justice Farmer of the Supreme Court of Illinois) "*would, be both legally and morally wrong.*"

We respectfully submit that no good reasons are shown in the brief filed on behalf of the respondent why the contentions in our opening brief on behalf of the petitioner should not be sustained.

Respectfully submitted,

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IN THE

Supreme Court of the United States.

OCTOBER TERM, A. D. 1922.

No. 846.

FRANK G. GARDNER, as Trustee in Bank-
ruptcy of the O'GARA COAL COMPANY,
Petitioner.

vs.
CHICAGO TITLE AND TRUST COMPANY,
as Receiver of the LaSalle Street Trust and
Savings Bank,

Respondent.

Certiorari to the
United States
Circuit Court of
Appeals for the
Seventh Circuit.

BRIEF AND ARGUMENT FOR PETITIONER.

STATEMENT OF THE CASE.

This case comes before this court upon a writ of certiorari granted to the petitioner, Frank G. Gardner, as Trustee in Bankruptcy of the O'Gara Coal Company, to review a decision of the United States Circuit Court of Appeals within and for the Seventh Circuit. The following is a brief statement of the facts in chronological order, the questions involved and the manner in which they were raised:

1. The O'Gara Coal Company is a corporation organized under the laws of the State of New York, duly licensed to transact business in the State of Illinois and having its chief business office in the City of Chicago.

It owned and operated coal mines in Saline County, Illinois, and also owned the entire capital stock of certain subsidiary coal companies, one of which was the Harrisburg Saline Collieries Company, an Illinois corporation, the capital stock of which consisted of 1,500 shares of the par value of one hundred dollars (\$100) each.

2. La Salle Street Trust and Savings Bank was a banking corporation organized in the year 1912 under an act of the Legislature of the State of Illinois entitled "An Act Concerning Corporations with Banking Powers, approved June 16, 1887, as amended." The La Salle Street Trust and Savings Bank was originally organized under the National Banking Act, but in the year 1912 surrendered its charter and became incorporated under the Banking Act of Illinois.

3. On *August 5, 1913*, the District Court of the United States, for the Northern District of Illinois, pursuant to Section 61 of the Bankruptcy Act, entered an order of record appointing and designating the La Salle Street Trust and Savings Bank as a depository of moneys of bankrupt estates in the district, and said La Salle Street Trust and Savings Bank (hereinafter called "the Depository") executed an acceptance of the appointment and filed in the District Court its bond, with the Illinois Surety Company as surety, in the penal sum of fifty thousand dollars (\$50,000), conditioned as follows:

"The Condition of this obligation is such that whereas, the District Court of the United States for the Northern District of Illinois, Eastern Division thereof, by its order entered of record on the 5th day of August, A. D. 1913, has appointed and designated the La Salle Street Trust & Savings Bank as a depository of money of bankrupt estates under and by virtue of an act to establish a uniform system of bankruptcy through the United States, approved July 1, A. D. 1898, and all amendatory acts thereof, which appointment and designation has been duly

executed by the La Salle Street Trust & Savings Bank; *Now, therefore, if the La Salle Street Trust & Savings Bank shall and does at all times faithfully and honestly keep and fully account for and pay over according to law all deposits and funds which it shall at any time receive or become accountable for as such depository under and by virtue of the appointment and designation as aforesaid, then the obligation shall be void; otherwise, the same shall remain in full force and effect."*

4. On September 8, 1913, the Depository, for a valuable consideration, acquired the promissory note of the O'Gara Coal Company for the principal sum of fifteen thousand dollars (\$15,000), dated September 6, 1913, payable on demand, at the La Salle Street Trust and Savings Bank, to the order of Charles B. Munday (who was then vice-president of the Depository), with interest at the rate of six per cent (6%) per annum after the date thereof. To secure the payment of said note the O'Gara Coal Company delivered to the payee fifteen hundred (1,500) shares of the capital stock of the Harrisburg Saline Collieries Company, an Illinois corporation, of the par value of one hundred dollars (\$100) each, constituting the entire authorized issue of capital stock of said corporation. On September 8, 1913, Charles B. Munday, vice-president of the Depository, for a valuable consideration, endorsed the promissory note in blank, without recourse, and delivered it to the Depository, together with the collateral described in said note.

5. On September 13, 1913, a petition was filed in the District Court of the United States for the Northern District of Illinois, to declare the O'Gara Coal Company a bankrupt. On October 3, 1913, an order of adjudication was entered. On November 11, 1913, Thomas J. O'Gara, Fred A. Busse and Edward Weltman were appointed and qualified as trustees in bankruptcy of the O'Gara Coal Company.

6. At various times between November 11, 1913, and June 11, 1914, the trustees in bankruptey of the O'Gara Coal Company deposited funds of the bankrupt estate in the Depository, which said deposits were duly credited to said trustees in bankruptey on the books of said Depository, and said deposits, at the close of business on June 11, 1914 (when said Depository suspended), aggregated the sum of nineteen thousand eight hundred forty-three dollars and sixty-two cents (\$19,843.62). (Rec., 5.) During this period the Depository continued to be at all times the owner and holder of the promissory note of the O'Gara Coal Company for fifteen thousand dollars (\$15,000) above referred to, together with the collateral securing the same.

7. On *June 12, 1914*, the Depository, having become insolvent, closed its doors, and on June 18, 1914, a bill of complaint in equity was filed in the Circuit Court of Cook County, Illinois, in the name and on behalf of the People of the State of Illinois *ex rel* James J. Brady, Auditor of Public Accounts (acting through the Attorney General of the State of Illinois) for the dissolution of the charter of the Depository and for the appointment of a receiver for the winding up of its affairs on the ground that it was insolvent and was being conducted in an illegal, fraudulent and unsafe manner, and on June 19, 1914, William C. Niblack was appointed receiver, and as such receiver he took possession of the assets of the Depository, included among which was the promissory note of the O'Gara Coal Company above referred to, together with the collateral securing the same. William C. Niblack continued to act as receiver until his death in 1920, when the respondent, Chicago Title and Trust Company, was appointed as his successor and has continued as such and is now acting as receiver of the Depository.

8. In *July, 1914*, Fred A. Busse, one of the trustees

in bankruptcy of O'Gara Coal Company, died, and on July 28, 1914, William C. Niblack (who was also receiver of the Depository), was appointed and qualified as successor trustee to Fred A. Busse. O'Gara, Weltman and Niblack continued to act as trustees until June 30, 1916, at which time William C. Niblack became the sole trustee in bankruptcy of said bankrupt estate and continued to act as such up to the time of his death on June 6, 1920.

9. On *September 11, 1914*, the receiver of the Depository filed with the receiver in bankruptcy a claim against the bankrupt estate of the O'Gara Coal Company in the form of proof of unsecured debt, upon the promissory note of \$15,000, which proof of debt was amended on October 21, 1917, as a secured claim on said note. (Rec., 7, 1112.)

10. On *June 5, 1916*, William C. Niblack, Thomas J. O'Gara and Edward Weltman, as trustees in bankruptcy of O'Gara Coal Company, filed in said proceeding in the Circuit Court of Cook County, Illinois, their petition setting forth the deposit by said trustees in bankruptcy in said Depository, prior to the suspension thereof, of the said sum of \$19,843.62, and praying said Circuit Court to allow in favor of said Trustee a *preferred claim* to the amount of \$19,843.62, and to adjudge the same entitled to priority of payment out of the assets of said Depository in the possession of the receiver, in advance of the general unsecured creditors, or in the event that priority of said claim was denied, that the claim might be allowed as a general claim against the assets of the said Depository. (Rec., 6, 7.) After June 30, 1916, William C. Niblack acted as sole trustee in bankruptcy of the O'Gara Coal Company and also as receiver of the Depository. During the year 1916, William C. Niblack as receiver of the Depository, paid to himself as sole trustee in bank-

ruptey of the O'Gara Coal Company, a dividend of twenty-five per cent (25%) upon his claim as trustee. In 1918 Niblack, as receiver of the Depository, paid to Niblack as trustee in bankruptey of the O'Gara Coal Company, another dividend of ten per cent (10%).

11. On *May 22, 1918*, William C. Niblack, as trustee in bankruptey of the O'Gara Coal Company, filed a verified petition with the referee in the bankruptey proceedings (Rec., 16, 19), in which he represented that he was the sole acting trustee in bankruptey of the coal company, vested with the exclusive right, title and interest in and to its assets as of September 13, 1913. He alleged the execution and delivery of the promissory note by the O'Gara Coal Company to Munday on September 6, 1913, and its endorsement and delivery by Munday to the Depository. He further alleges the deposit of funds of the bankrupt estate of the O'Gara Coal Company by the trustees in the Depository aggregating, on June 18, 1914, \$19,843. He also alleges that on June 13, 1914, the Depository ceased to transact business and the filing of the bill in equity on the relation of James J. Brady, Auditor of Public Accounts, and the appointment of himself as receiver. He further alleges that no part of the deposits have been paid except the sum of \$4,963.35, representing the dividend of 25 per cent declared and paid by him as receiver.

12. Niblack, as trustee, further represents that by virtue of Section 68 of the Bankruptey Act he is entitled to set-off against his claim as receiver of the Depository, the amount due the bankrupt estate of the O'Gara Coal Company, and that upon payment of such balance the collateral held by him as receiver be released and delivered to him as trustee.

13. On *May 27, 1918*, William C. Niblack, as receiver of the Depository, filed an answer to his petition as sole

trustee in bankruptey of the O'Gara Coal Company, in which he denies that by virtue of Section 68 of the Bankruptey Act, Niblack, as trustee in bankruptey, is entitled to set-off against the claim of Niblack as receiver of the Depository, the said sum of \$14,880.27, or any portion thereof, but on the contrary, as receiver he alleges that the petitioner, as trustee, is not entitled to set-off any amount whatever against the amount of said promissory note held by him as receiver of the Depository. (Rec., 19, 20.)

14. On *October 26, 1920*, upon the hearing of this petition, Sidney C. Eastman, referee in bankruptey, entered an order (Rec., 3, 8), adjudging and decreeing that the prayer of the petition (filed by William C. Niblack as sole trustee in bankruptey of the O'Gara Coal Company, praying for set-off) be granted, and that the trustee pay the receiver of the Depository the amount due on said promissory note, after allowing as a set-off \$12,894.93 (the amount of the funds of the bankrupt estate deposited by the trustees with the Depository, less dividends of \$4,963.35 and \$1,985.34), and that upon the payment of said amount the liability of the bankrupt upon said note be extinguished, the collateral surrendered by the receiver to the trustee and the claims filed by the receiver stand as satisfied on the records of the bankrupt estate.

15. On *November 1, 1920*, Chicago Title and Trust Company, as receiver of the Depository, filed in the District Court its petition to review this order.

16. On *February 3, 1921*, a petition for review was heard by Honorable George A. Carpenter, district judge, who on that date entered an order (similar in all respects to the order entered by the referee) granting the prayer of the petition of the trustee in bankruptey to set-off the net amount on deposit with the Depository, less dividends,

against the promissory note of the bankrupt coal company.

17. On *February 11, 1921*, Chicago Title and Trust Company, as receiver of the Depository, filed in the District Court its petition for appeal to the Circuit Court of Appeals (Rec., 29, 30), and an order was entered the same day allowing its appeal. On February 11, 1921, a petition to review and revise was also filed in the United States Circuit Court of Appeals for the same circuit, to review the order of the District Court above referred to. (Rec., 57, 58, 59.) On March 31, 1921, an order was entered by the Circuit Court of Appeals consolidating the petition to review and revise and the appeal, and directing that they be heard together. (Rec., 60.)

18. On January 3, 1922, the United States Circuit Court of Appeals entered an order remanding the proceeding to the District Court, with directions to set aside the order or decree of the District Court appealed from and directing that the petition to set-off the claims be dismissed. (Rec., 52.)

The decision of the Circuit Court of Appeals is reported in 278 Federal Reports, page 509.

The court bases its conclusion that the right of set-off does not exist solely upon the ground that the depository could not have asserted a right to set-off the note of the bankrupt against the moneys of the bankrupt estate deposited by the trustees. The court's view is that mutuality is essential in order to give a right of set-off. Therefore it concludes no right of set-off can exist in favor of the trustee in bankruptcy of the coal company against the note of the bankrupt held by the receiver of the Depository. The reasoning of the court is predicated entirely upon the doctrine that the right of set-off must be mutual.

The fact that the bank was a depository and acting in a fiduciary capacity under an appointment by the bankruptcy court, the Court of Appeals held, had no effect whatever upon the rights of the trustees, saying,

"The fact that this bank was a depository which under the law the court had designated as such also militates against the proposition of mutuality of debt. To the extent that legally authorized depositories are less than the whole number of banks, the choice of the trustee is narrowed to such banks as have been duly authorized. Had there been but one, the trustee would have only 'Hobson's choice.' *Surely it could not have been intended that, in limiting the number of depositories in which such funds may be placed, there be incurred even remotely the risk of the lawful appropriation of funds to which normally all creditors are entitled to the claim of one creditor whose legal or equitable standing was not different from the others, save only in the fortuitous circumstance that the court's officer happened to deposit there funds of the bankrupt estate.*'"

On May 9, 1919, the District Court entered an order in the bankruptcy proceedings of the O'Gara Coal Company providing for the payment in full of its claims (O'Gara Coal Company, 260 Federal Reporter 742), so that the effect of the decision of the Circuit Court of Appeals in this proceeding would be that the receiver of the recalcitrant depository shall be paid in full by the very court whose trust funds the depository misappropriated, while the trustee in bankruptcy must go to the state court and get what it can from the receiver in that proceeding.

The decision of the Circuit Court of Appeals is based upon the premise that the deposit of funds of a bankrupt estate in a depository designated pursuant to the provisions of the Bankruptcy Act creates only the relation of debtor and creditor between the depository and the trustees of the bankrupt estate, and that if the depository misappropriates or converts the trust funds of the bank-

rupt estate there is no moral wrong involved, but it merely creates a debt in favor of the trustees as "*creditors.*" The Court of Appeals refers to such a deposit of trust funds in a depository which has misappropriated and converted the trust funds of the bankrupt estate as "**THE CLAIM OF ONE CREDITOR whose legal or equitable standing was not different from the others** save only in the fortuitous circumstance that the court's officer happened to deposit there the funds of the bankrupt estate."

Under this decision, therefore, the question arises whether a depository which has accepted a trust pursuant to the provisions of the Bankruptcy Act and then converted trust funds entrusted to it pursuant to the court's appointment, is to be treated as a wrongdoer which has violated its trust which, when it asserts the claim against the bankrupt estate which it has looted and does not come into equity with clean hands, or whether it can with impunity come into the *very bankruptcy court that appointed it and, without restoring the funds it has misappropriated, assert a claim against the same bankrupt estate whose funds were entrusted to it and be treated on the basis of an ordinary creditor.*

SPECIFICATION OF ERRORS RELIED ON.

I.

The Circuit Court of Appeals erred in remanding this cause to the District Court with directions to set aside the order or decree of the District Court appealed from.

II.

The Circuit Court of Appeals erred in ordering that the petition to set off the claims be dismissed.

III.

The Circuit Court of Appeals erred in entering the order on the petition to review and revise, setting aside the order of the District Court and directing that the petition to set off the claims be dismissed.

IV.

The Circuit Court of Appeals erred in ordering the costs on the appeal to be taxed against the appellee.

V.

The Circuit Court of Appeals erred in ordering that the costs on the petition to review and revise be taxed against the respondent.

BRIEF.

I.

UNDER THE PROVISIONS OF THE BANKRUPTCY ACT THE RELATION OF A DEPOSITORY TO THE TRUSTEES OF BANKRUPT ESTATES IS A **FIDUCIARY RELATION**, AND IS NOT THE USUAL DEBTOR-CREDITOR RELATION WHICH A BANK SUSTAINS TOWARDS ITS ORDINARY COMMERCIAL DEPOSITORS.

IF THE RELATION OF A DEPOSITORY TO THE TRUSTEES WHO DEPOSIT FUNDS OF BANKRUPT ESTATES IS MERELY THAT OF DEBTOR AND CREDITOR THEN THE PROVISIONS OF THE ACT AND THE COVENANTS IN THE BOND OF THE DEPOSITORY ARE MEANINGLESS.

IF THE DEPOSITORY EMBEZZLES OR MISAPPROPRIATES OR CONVERTS TO ITS OWN USE THE TRUST FUNDS OF BANKRUPT ESTATES DEPOSITED WITH IT FOR SAFEKEEPING, AND FAILS OR REFUSES TO "PAY THEM OVER ACCORDING TO LAW," IT HAS BETRAYED THE TRUST REPOSED IN IT BY LAW AND BY THE COURT, JUST AS MUCH AS THOUGH A TRUSTEE OR RECEIVER OR CUSTODIAN OR A MARSHAL HAD CONVERTED OR MISAPPROPRIATED A PART OF THE ESTATE OF A BANKRUPT IN HIS POSSESSION.

A DEPOSITORY IS TO ALL INTENTS **AN OFFICER OF THE COURT**. MONEYS DEPOSITED IN A DESIGNATED DEPOSITORY ARE **IN CUSTODIA LEGIS**.

Ex parte Prescott, 19 Fed. Cases 1283 (2 Gal-lison's reports 145).

Morris v. Carnegie Trust Co., 139 N. Y. Supp. 969. (Reversed on a different point, 213 N. Y. 185.)

- Jones v. Merchants National Bank of Boston*, 76 Fed. Rep. 683 (35 L. R. A. 698).
- Corbitt v. Farmers' Bank of Delaware*, 114 Fed. Rep. 602.
- Osborne v. United States*, 91 U. S. 474.
- First National Bank of Cripple Creek v. Londonderry Mining Co.*, 114 Pac. 313.
- Thomas v. Chicago, etc., Railroad Co.*, 37 Fed. Rep. 548.
- Fagan v. Cullen*, 28 Fed. Rep. 843.
- U. S. v. Mason*, 218 U. S. 517.

Bankruptcy Act, Section 61, is as follows:

Depositories for Money: "Courts of bankruptcy shall designate, by order, banking institutions as depositories for the money of bankrupt estates, as convenient as may be to the residences of trustees, and shall require bonds to the United States, subject to their approval, to be given by such banking institutions, and may from time to time as occasion may require, by like order increase the number of depositories or the amount of any bond or change such depositories."

Section 50h is as follows:

"Bonds of referees, trustees and designated depositories shall be filed of record in the office of the clerk of the court and may be sued upon in the name of the United States for the use of any person injured by a breach of their conditions."

Section 47a is in part as follows:

"Trustees shall respectively deposit all money received by them in one of the designated depositories."

These sections are mandatory.

87 C. C. A. 521.
Huttig Mfg. Co. v. Edwards, 160 Fed. Rep. 619;

Bankruptcy Rule XXIX is as follows:

(104) "No moneys deposited as required by the act shall be drawn from the depository unless by check or warrant, signed by the clerk of the court, or by a trustee, and countersigned by the judge of the court, or by a referee designated for that purpose, or by the clerk or his assistant under an order made by the judge, stating the date, the sum, and the account for which it is drawn; and an entry of the substance of such check or warrant, with the date thereof, the sum drawn for, and the account for which it is drawn, shall be forthwith made in a book kept for that purpose by the trustee or his clerk; and all checks and drafts shall be entered in the order of time in which they are drawn, and shall be numbered in the case of each estate. A copy of this general order shall be furnished to the depository, and also the name of any referee or clerk authorized to countersign said checks."

*et al
Feb 24, 1897
Stat.* Sections 995 and 996 of the Revised Statutes, as amended by the Act of February 19, 1897, c. 265, Section 3, 29 Stats. 578 (U. S. Compiled Statutes, 1901, page 711), are as follows:

995. "All moneys paid into any court of the United States or received by the officers thereof in any case pending or adjudicated in such court shall be forthwith deposited with the Treasurer, an assistant treasurer, or a designated depository of the United States, in the name and to the credit of such court; *provided*, that nothing herein shall be construed to prevent the delivery of any such money upon security, according to agreement of parties, under the direction of the court."

996. "No money deposited as aforesaid shall be withdrawn except by order of the judge or judges of said courts, respectively, in term or in vacation, to be signed by such judge or judges, and to be entered and certified of record by the clerk; and every such order shall state the cause in or on account of which it is drawn. And it shall be the duty of the judge or judges of said courts, respectively, to cause any moneys deposited as aforesaid, which have re-

mained in the registry of the court unclaimed for ten years or longer, to be deposited in a designated depository of the United States, to the credit of the United States."

The Act of March 24, 1871, c. 2, Secs. 1, 4, Vol. 17, Stat. at Large 1, as amended in 1875 (18 Stat. at Large 320) Vol. 3 U. S. Comp. Stat. 1901, pages 3710 and 3711, is as follows:

See. 5504:

"Every clerk or other officer of a court of the United States, who fails forthwith to deposit any money belonging in the registry of the court, or hereafter paid into court or received by the officers thereof, with the Treasurer, assistant treasurer, or a designated depository of the United States, in the name and to the credit of such court, or who retains or converts to his own use or to the use of another any such money, is guilty of embezzlement, and shall be punished by fine not less than five hundred dollars, and not more than the amount embezzled, or by imprisonment not less than one year nor more than ten years, or by both such fine and imprisonment; but nothing herein shall be held to prevent the delivery of any such money upon security, according to agreement, of parties under the direction of the court."

See. 5505:

"Every person who knowingly receives, from a clerk or other officer of a court of the United States, any money belonging in the registry of such court, as a deposit, loan, or otherwise, is guilty of embezzlement, and shall be punished as prescribed in the preceding section."

The Act of Congress of March 3, 1857 (11 Stats. at Large, 249, Ch. 114), (U. S. Compiled Stats., Vol. 3, Sec. 5489), is as follows:

"If the treasurer of the United States, or any assistant treasurer, OR ANY PUBLIC DEPOSITORY, fails safely to keep all moneys deposited by any disbursing officer or disbursing agent, as well as all moneys

deposited by any receiver, collector, or other person having moneys of the United States, he shall be deemed guilty of embezzlement of the moneys so safely kept, and shall be imprisoned not less than six months nor more than ten years, and fined in a sum equal to the amount of money so embezzled."

II.

BANKRUPTCY COURTS ARE COURTS OF EQUITY AND SHOULD BE GOVERNED BY EQUITABLE PRINCIPLES.

Sabin v. Larkin-Green Co., 218 Fed. 984.

In re Swofford Bros. Dry Goods Co., 180 Fed. 549.

Bardes v. Howarden, 178 U. S. 524, 20 Sup. Ct. Rep. 1000.

Dodge v. Norlin, 133 Fed. 363.

In re Siegel-Hillman's Dry Goods Co., 111 Fed. 980.

In re Filmar, 177 Fed. 170.

In re Hawks, 204 Fed. 309.

7 Corpus Juris, 27.

In re Gillaspie, 190 Fed. 88.

Mason v. Wolkowich, 150 Fed. 699, 10 L. Rep. Ann. N. S. 765.

In re Rochford, 124 Fed. 182.

Swarts v. Siegel, 117 Fed. 13.

III.

- (a) "HE WHO SEEKS EQUITY SHOULD DO EQUITY." "HE WHO COMES INTO EQUITY SHOULD DO SO WITH CLEAN HANDS."
- (b) THE CIRCUIT COURT OF APPEALS BASED ITS DECISION UPON THE TECHNICAL RULES OF SET-OFF, THE OFFICIAL RELATION OF TRUST OF THE DEPOSITORY TO THE BANKRUPT ESTATE AND THE BREACH OF THAT TRUST BY THE DEPOSITORY, WERE NOT CONSIDERED AS AFFECTING THE STATUS OF THE CLAIM OF THE DEPOSITORY NOR TO JUSTIFY THE DISTRICT COURT IN IMPOSING CONDITIONS TO PREVENT ITS PARTICIPATION IN THE ASSETS OF THE BANKRUPT ESTATE UNTIL IT HAD MADE RESTORATION OF THE MISAPPROPRIATED FUND OF THE ESTATE.
- (c) ITS DECISION PERMITS THE DEPOSITORY WHICH HAS BREACHED ITS TRUST TO ASSERT ITS CLAIM AGAINST THE BANKRUPT ESTATE AND PARTICIPATE IN THE REMAINING ASSETS WITHOUT REQUIRING IT TO MAKE RESTORATION EVEN TO THE EXTENT OF ALLOWING THE COUNTER CLAIM OF THE BANKRUPT ESTATE FOR THE TRUST FUNDS OF THE ESTATE WHICH WERE CONVERTED BY THE DEPOSITORY TO BE SET OFF AGAINST THE CLAIM OF THE DEPOSITORY.
- (d) THE EFFECT OF THEIR DECISION IS THAT THE RECEIVER OF THE ERRANT DEPOSITORY WILL BE PAID ITS CLAIM IN FULL WHILE THE BANKRUPT ESTATE WHICH HAS SUFFERED THROUGH THE DEPOSITORY'S BREACH OF TRUST WILL RECEIVE LESS THAN FIFTY PER CENT OF ITS COUNTER CLAIM. WE BELIEVE THIS IS BOTH LEGALLY AND MORALLY WRONG.
- (e) SUCH A RECREANT OFFICER SHOULD NOT BE PERMITTED TO ASSERT A CLAIM IN THE COURT THAT APPOINTED IT AGAINST THE REMNANT OF THE VERY ESTATE IT HAS LOOTED, AT LEAST NOT UNTIL IT HAS MADE RESTORATION OF THE MISAPPROPRIATED FUNDS, NOR SHOULD THAT RESTORATION (WHERE THE CIRCUMSTANCES PERMIT IT TO BE WORKED OUT THROUGH THE MEDIUM OF A SET-OFF) BE MADE CONDITIONAL UPON WHETHER THERE WOULD BE A TECHNICAL RIGHT OF SET-OFF IF THE CASE WERE AN ORDINARY ACTION AT LAW, i. e., WHETHER THERE IS STRICT MUTUALITY.

IV.

IN EQUITY, MUTUALITY IS NOT ESSENTIAL TO A SET-OFF,
BUT IN THIS CASE THERE IS ACTUAL AND EQUITABLE MU-
TUALITY.

- People v. California Safe Deposit & Trust Co.*,
141 Pae. (Cal.) 1181.
Smith v. Kearney, 2 Barb. Ch. (N. Y.) 533, 549.
Porter v. Roseman, 74 N. E. 1105.
In re Bell's Estate, 141 Pae. (Cal.) 1179.
In re Harper, 175 Fed. 412, 426.
In re Siegel-Hillman Dry Goods Co., 111 Fed.
980.
*North Chicago Rolling Mills Company v. St.
Louis Ore Company*, 14 Sup. Ct. 710.
Lindsay v. Jackson, 2 Paige's Ch. (N. Y.) 580.
Receivers v. Paterson Gas Light Company, 23
N. J. Law 283, 294.
34 Cye. 644.
Chandler v. Drew, 6 N. H. 469, 26 Ann. Dec. 704,
707.
Morse on Banks (4th Ed.), Par. 338.
Brewer v. Norcross, 17 N. J. Eq. 219, 225.
Waterman on Set-off, Par. 218.
Hughes v. Traherne, Admx., 64 Ill. 48.
Scott v. Armstrong, 146 U. S. 499, 13 Sup. Ct.
Rep. 148.
Smith v. Perry, 95 S. W. (Mo.) 337.
St. Paul & Minn. Trust Co. v. Leck, 57 Minn. 87,
58 N. W. 826.
C. D. & V. R. R. Co. v. Field, 86 Ill. 270, 272.

V.

A COURT OF BANKRUPTCY WILL EXERCISE THIS EQUITABLE JURISDICTION IN THE MATTER OF EQUITABLE SET-OFFS IN ALL CASES COMING BEFORE IT IN WHICH A COURT OF CHANCERY WOULD EXERCISE SUCH JURISDICTION.

Cumberland Glass Mfg. Co. v. DeWitt, 237 U. S. 447, 35 Sup. Ct. Rep. 636.

Receivers v. Patterson Gas Light Co., 23 N. J. Law, 283-288.

Scott v. Armstrong, 146 U. S. 499, 13 Sup. Ct. Rep. 148.

In re Bell's Estate, 141 Pac. (Cal.) 1179.

People v. California Safe Deposit & Trust Co., 141 Pac. (Cal.) 1181.

VI.

COURTS OF EQUITY EXERCISE A JURISDICTION IN MATTERS OF SET-OFFS, INDEPENDENT OF THE STATUTES ON THE SUBJECT.

34 Cyc. 633.

Scott v. Armstrong, 146 U. S. 499, 13 Sup. Ct. Rep. 148.

North Chicago Rolling Mills Co. v. St. Louis Ore Co., 14 Sup. Ct. Rep. 710.

Lindsay v. Jackson, 2 Paige's Chan. (N. Y.) 580.

Receivers v. Patterson Gas Light Co., 23 N. J. Law, 283.

Smith v. Perry, 95 S. W. (Mo.) 337.

Eigenman v. Clark, 51 N. E. (Ind.) 725, 726.

Blake v. Langdon, 47 Am. Dec. 701, 705, 19 Vt. 485.

Richardson v. Doty, 62 N. W. (Neb.) 254.

Jeffries v. Evans, 43 Am. Dec. 158, 6 B. Monroe (Ky.) 119.

VII.

A PARTY WHO FILES A CLAIM AS A CREDITOR IN A BANKRUPTCY PROCEEDING SUBMITS TO THE JURISDICTION OF THE COURT ALL QUESTIONS AS TO THE RIGHT OF SET-OFF IN BEHALF OF THE BANKRUPTCY ESTATE AGAINST SUCH CLAIM.

In re Harper, 175 Fed. 412-424.

In re Siegel-Hillman Dry Goods Co., 111 Fed. 980.

VIII.

IT IS A RULE UNIVERSALLY RECOGNIZED AND APPLIED THAT THE INSOLVENCY OF THE PARTY AGAINST WHOM A SET-OFF IS SOUGHT GIVES RISE TO THE EQUITABLE INTERVENTION OF A COURT OF CHANCERY AND EQUITABLE SET-OFF WILL BE ALLOWED, EVEN THOUGH NOT ALLOWABLE AT LAW OR UNDER THE STATUTES.

IN SUCH CASES A WANT OF MUTUALITY OR THE FACT THAT THE CLAIM SOUGHT TO BE SET-OFF IS UNLIQUIDATED OR THAT THE PARTIES ARE SUING IN DIFFERENT CAPACITIES, THE REAL INTERESTS, HOWEVER, BEING THE SAME, AND OTHER OBJECTIONS PREVENTING THE SET-OFF AT LAW WILL NOT PREVENT AN EQUITABLE SET-OFF.

34 Cyc. 638, 717, 724.

North Chicago Rolling Mills Co. v. St. Louis Ore Co., 14 Sup. Ct. Rep. 710-716.

Central Appalachian Co. v. Buchanan, 90 Fed. 454.

Brewer v. Norcross, 17 N. J. Eq. 219-225.

Hughes v. Traherne, Adm., 64 Ill. 48.

C. D. & V. R. R. Co. v. Field, 86 Ill. 270, 272.

Hahn v. Gates, 102 Ill. App. 385, 387.

Quick v. Lemon, 105 Ill. 578, 586.

Engs v. Matson, 11 Ill. App. 639.

Ehrat v. Marrone, 191 Ill. App. 121.

Lindsay v. Jackson, 2 Paige's Ch. (N. J.) 580.

- Porter v. Roseman*, 74 N. E. (Ind.) 1105.
Barbour on Set-off, page 190.
Smith v. Perry, 95 S. W. (Mo.) 337.
St. Paul & Minnesota Trust Co. v. Leck, 57 Minn. 87, 58 N. W. 826.
Dubrueil v. Gaither, 56 Atl. (Md.) 965.
Dale v. Cooke, 4 Johnson's Ch. 11.
People v. California Safe Deposit & Trust Co. 141 Pac. (Cal.) 1181.
McLane v. Johnson, 9 Atl. (Vt.) 837.
Eigenman et al. v. Clark, et al., 51 N. E. (Ind.) 725.
Bibb Land-Lumber Co. v. Lima Machine Works, 30 S. E. (Ga.) 676.
In re Crystal Spring Bottling Co., 100 Fed. 265.
Doane v. Walker, 101 Ill. 628.
Walker v. Doane, 108 Ill. 236.
Jeffries v. Evans, 43 Am. Dec. 158 (6 B. Monroe Ky.) 119.
Waterman on Set-off, Par. 210.
Smith v. Kearney, 2 Barb. Ch. 549.
Jeff. v. Wood, 2 P. Wms. Rep. 128.

ARGUMENT.

I.

UNDER THE PROVISIONS OF THE BANKRUPTCY ACT THE RELATION OF A DEPOSITORY TO THE TRUSTEES OF BANKRUPT ESTATES IS A **FIDUCIARY RELATION**, AND IS NOT THE USUAL DEBTOR-CREDITOR RELATION WHICH A BANK SUSTAINS TOWARDS ITS ORDINARY COMMERCIAL DEPOSITORS.

IF THE RELATION OF A DEPOSITORY TO THE TRUSTEES WHO DEPOSIT FUNDS OF BANKRUPT ESTATES IS MERELY THAT OF DEBTOR AND CREDITOR, THEN THE PROVISIONS OF THE ACT AND THE COVENANTS IN THE BOND OF THE DEPOSITORY ARE MEANINGLESS.

IF THE DEPOSITORY EMBEEZLES OR MISAPPROPRIATES OR CONVERTS TO ITS OWN USE THE TRUST FUNDS OF BANKRUPT ESTATES DEPOSITED WITH IT FOR SAFEKEEPING AND FAILS OR REFUSES TO "PAY THEM OVER ACCORDING TO LAW," IT HAS BETRAYED THE TRUST REPOSED IN IT BY LAW AND BY THE COURT JUST AS MUCH AS THOUGH A TRUSTEE OR RECEIVER OR CUSTODIAN OR A MARSHAL HAD CONVERTED OR MISAPPROPRIATED A PART OF THE ESTATE OF A BANKRUPT IN HIS POSSESSION.

A DEPOSITORY IS TO ALL INTENTS **AN OFFICER OF THE COURT**. MONEYS DEPOSITED IN A DESIGNATED DEPOSITORY ARE IN **CUSTODIA LEGIS**.

A.

THE RELATION OF A DEPOSITORY TO THE TRUSTEES OF BANKRUPT ESTATES IS A FIDUCIARY RELATION.

The Bankruptcy Act of 1867 contains no provision for the appointment of depositories. However, the Supreme Court, by its general orders* provided for the designation by the District Courts of *National Banks* as depositories, and required that all moneys received by assignees should be deposited therein.

The English Bankruptcy Law of 1883 (46 and 47 Vict. Ch. 52) makes careful provision for the conservation of

*No. 28 of the General Orders of the Supreme Court under the Act of 1867 provides for the designation by the District Court of National Banks as depositories, in which all moneys received by assignees shall be deposited, and that every assignee shall deposit all sums received by him on account of any bankrupt estate in one designated depository.

funds of bankrupt estates. In this respect it is far superior to either the Act of 1867 or the Act of 1898. The administration of bankrupt estates is under the supervision of the Board of Trade, which not only appoints the official receivers, but whose officer, called "Inspector General in Bankruptcy," supervises the administration of estates by receivers and trustees. An account called the Bankruptcy Estates Account is kept by the Board of Trade with the Bank of England, and all moneys received by receivers and trustees are required to be at once paid into that Account, whereupon the Board of Trade furnishes him with a certificate in the nature of a receipt.

The Board of Trade regulations contain strict provisions for audit of the accounts of receivers and trustees under the supervision of the Inspector General in Bankruptcy. (a)

(a) Par. 66(1):

"The Board of Trade may, at any time after the passing of this Act, and from time to time, appoint such persons as they think fit to be official receivers of debtors' estates, and may remove any person so appointed from such office. The official receivers of debtors' estates shall act under the general authority and directions of the Board of Trade, but shall also be officers of the courts to which they are respectively attached."

Par. 70(3):

"Every official receiver shall account to the Board of Trade and pay over all moneys and deal with all securities in such manner as the Board from time to time direct."

Portions of paragraph 74 are as follows:

(1) An account called the Bankruptcy Estates Account shall be kept by the Board of Trade with the Bank of England, and all moneys received by the Board of Trade in respect of proceedings under this Act shall be paid to that account.

(3) Every trustee in bankruptcy shall, in such manner and at such times as the Board of Trade with the concurrence of the Treasury direct, pay the money received by him to the Bankruptcy Estates Account at the Bank of England, and the Board of Trade shall furnish him with a certificate of receipt of the money so paid.

(6) If a trustee at any time retains for more than ten days a sum exceeding fifty pounds, or such other amount as the Board of Trade in any particular case authorize him to retain, then, unless he explains the retention to the satisfaction of the Board of Trade, he shall pay interest on the amount so retained in excess at the rate of twenty pounds per centum per annum, and shall have no claim for remuneration, and may be removed from his office by the Board of Trade, and shall be liable to pay any expenses occasioned by reason of his default.

(7) All payments out of money standing to the credit of the Board of Trade in the Bankruptcy Estates Account shall be made by the Bank of England in the prescribed manner."

Par. 75:

"No trustee in a bankruptcy or under any composition or scheme of arrangement shall pay any sums received by him as trustee into his private banking account."

The Bank of England is, of course, a quasi governmental institution, and the Act makes express provision for the investment of funds of bankrupt estates in Government securities under the supervision of the Treasury whenever, in the opinion of the Board of Trade, it is not required for the time being by the bankrupt estates. (b)

Possibly the careful provisions of the English Bankruptcy Act of 1883 were responsible for the provisions in the Bankruptcy Act of 1898 in relation to depositaries. However that may be, Congress made provision in that Act for the appointment by court order of depositaries.

Congress, however, refused to be guided by the wisdom of the Supreme Court in requiring depositaries to be National Banks, and in Section 61 of the Bankruptcy Act of 1898 (c) substituted the words "Banking Institutions," whatever that phrase means.

It is possible that under this term District Courts might designate *private banking firms, which are under no supervision of any kind, either National or State.* "Banking Institutions" is a high-sounding phrase, but there could be no purpose in using that term unless it

(b) Par. 76:

"(1) Whenever the cash balance standing to the credit of the Bankruptcy Estates Account is in excess of the amount which in the opinion of the Board of Trade is required for the time being to answer demands in respect of bankrupt's estates, the Board of Trade shall notify the same to the Treasury, and shall pay over the same or any part thereof as the Treasury may require to the Treasury, to such account as the Treasury may direct, and the Treasury may invest the said sums or any part thereof in Government securities to be placed to the credit of the said account.

(2) Whenever any part of the money so invested is, in the opinion of the Board of Trade, required to answer any demands in respect of bankrupts' estates, the Board of Trade shall notify to the Treasury the amount so required, and the Treasury shall thereupon repay to the Board of Trade such sum as may be required to the credit of the Bankruptcy Estates Account, and for that purpose may direct the sale of such part of the said securities as may be necessary.

(3) The dividends on the investments under this section shall be paid to such account as the Treasury may direct, and regard shall be had to the amount thus derived in fixing the fees payable in respect of bankruptcy proceedings."

was intended not to restrict the selection of depositories to banks organized under the National Banking Act or under State banking acts. That Congress should as late as 1898 enact a provision that would permit trust funds of bankrupt estates to be deposited with a private banking firm seems incredible. The wisdom of the Supreme Court's provision under the General Orders under the Act of 1867 for the appointment of National Banks as depositories seems to be justified by the fact that most of the depositories which have failed were State banks. The two most notable instances are the Carnegie Trust Company of New York and the La Salle Street Trust & Savings Bank of Chicago.

Notwithstanding the use of the unfortunate phrase "Banking Institutions," we believe Congress intended, by the provisions of the Bankruptcy Act of 1898, to safeguard the funds of bankrupt estates when it inserted in the Act provisions for the designation of banking institutions as depositories by court order and compelled trustees to deposit all moneys received by them therein.

Section 50 (h)* classes designated depositories with referees and trustees and requires that their bonds be filed of record in the office of the clerk of the court. The District Court is given power to increase the amount of the depository's bond, and their bonds must be approved by the court before they can qualify.

We believe Congress, by these provisions in the Bankruptcy Act, intended to put the deposit of trust funds of bankrupt estates upon a different footing from ordinary deposits and so far as possible to guard against the loss of trust funds of bankrupt estates by restricting the depositories' right to deal with them as a banker and

*"Bonds of referees, trustees and designated depositories shall be filed of record in the office of the clerk of the court and may be sued upon in the name of the United States for the use of any person injured by a breach of their conditions."

requiring them to hold it as a custodian or trustee; in other words, we believe that Congress intended to avoid the relation of debtor and creditor which a banker and depositor ordinarily sustain to each other.

If a depository is neither an officer nor a quasi officer of the court and owes no duty to faithfully perform its obligation to bankrupt estates, but has only the status of a banker in relation to estates whose funds are entrusted to it for safekeeping, then the apparent intent of Congress as expressed in Sections 61(a), 50(h) and 47(a) is completely frustrated. It would seem strange if Congress, and the Federal courts charged with the administration of the Bankruptcy Act, cannot devise means to insure the safekeeping of trust funds of bankrupt estates and if a bank which has been designated as a depository fails, funds of the bankrupt estates are to be treated on the same basis as an ordinary depositor. Yet, this is precisely what has occurred in this case. Depositories have closed their doors, and not only the Court of Appeals of the Seventh Circuit (in the case at bar) but two District Courts* have expressly decided that the deposit of the trust funds of a bankrupt estate was entitled to no more consideration in law than the deposit of an ordinary individual, and that it created only the relation of debtor and creditor.

While this is the view of one Circuit Court of Appeals and two District Courts, strangely enough, in the case of United Grocery Co., where the bank was indebted to the depository in the sum of \$30,000 and the receiver had deposited \$7,586.04 of trust funds just before the depository closed its doors, *the referee entered exactly the kind of an order we think should have been entered in this case.*

**Re United Grocery Co.*, 253 Fed. 267, Dist. Ct., Southern District of Florida, 1919;
Re Bologh, 185 Fed. 825.

In that case the Receiver of an insolvent depository filed a claim against the bankrupt estate with the referee and the referee entered an order allowing his claim upon the repayment to the bankrupt estate by the receiver of the amount deposited by the bankrupt estate in the depository.

The District Judge, however, finding no express provision of the Act which specifically authorized an order of that particular character, adopted the narrow view that the Court had no power to enter it. He was unable to classify, as a statutory preference, the act of the Bank in converting the funds of the bankrupt estate entrusted to it as a depository by the Receiver, and was of the opinion that the whole transaction turned on the question of set-off, (express recognition of which is given by the Act in Section 68a). No reference whatever in the opinion is made to the reserve or general power which a court of bankruptcy, like any other court having equitable powers, has and ought not to hesitate to exercise under proper circumstances nor to the fact that the depository which had been guilty of a wrong in that capacity was invoking the aid of the court it had wronged.

In that case, as in the case at bar, the Receiver of the defaulting depository actually applied to the Bankruptcy Court administering the estate which had been impaired by the acts of the depository, to allow its claim without offering to make restoration, thus submitting his rights as Receiver of the depository to the jurisdiction of the Bankruptcy Court. (*In re Harper*, 175 Fed. Rep. 412, 422; *In re Siegel-Hillman Dry Goods Co.*, 111 Fed. Rep. 986.) As the facts in this case are in all respects analogous to the facts in the case at bar, and as the reasoning of the Circuit Court of Appeals in the case at bar follows that of the District Judge in the United Grocery Co. case, it would seem that the decision of the Court of Appeals of the Seventh Circuit was in great measure due to the

decision in the United Grocery Co. case. As a matter of fact, another District Judge*, in construing Section 68a, expressed the view that it included a liability that accrued to a trustee which had not accrued to the bankrupt when the claims and liability were mutual, but it is rather shocking to the moral sense to think that a situation of the kind dealt with in the United Grocery Co. case and in the case at bar should depend upon the application of the rules of set-off. A court might as well say that where an employe has stolen funds of his employer, the right of the employe to collect wages from his employer without restoring the stolen property depends upon the law of set-off. Money misappropriated under circumstances which involve moral turpitude or a breach of trust is not in the same category as a debt incurred for the purchase of merchandise, and if a court is going to condone the wrong by completely ignoring it and dealing with the transaction on a purely commercial basis, it is losing sight of the fact that an act which is morally wrong is almost always legally wrong. That the Circuit Court of Appeals decided the question involved here without taking into consideration elements of wrongdoing on the part of the depository in failing to perform its duties is perfectly clear from a reading of the opinion. The Court refers to the deposit of the trust funds by the Trustees in the depository as a "claim of one creditor whose legal or equitable standing was not different from the others," meaning other depositors in the LaSalle Street Trust & Savings Bank.

The question thus arises for determination whether a deposit of the trust funds of bankrupt estates by receivers or trustees, in an official depository appointed by the court, creates merely the relation of debtor and creditor. Aside from the decision of the Circuit Court of Appeals

**re Crystal Springs Bottling Co.*, 100 Fed. Rep. 265.

this case, and that of the District Court of Florida
we referred to, our research has only developed one
decision in which the court expressed the opinion that
such a deposit created only the debtor-creditor relation
which a banker ordinarily sustains to a depositor.

In this case, (*re Bologh*, 185 Fed. Rep. 825, Dist. Ct. S.
, N. Y. 1911), District Judge Holt expressed the opin-
ion that such a deposit merely created the same relation
between debtor and creditor as is created by any banker, but
his statement is really only dictum. In that case,
upon the failure of the Carnegie Trust Company,
the receivers of several bankrupt estates applied to the
District Court for summary orders requiring the Trust
Company, as a depository of the money of bankrupt es-
tates, to summarily pay over the amounts so deposited.
The learned District Judge was of the opinion that he
had no power to enter the orders asked for because he
had no summary jurisdiction under the circumstances.

Whether the conclusion reached by Judge Holt not to
interfere by summary proceedings was right or wrong
is not necessary to determine in this case, because in
this case the Receiver of the depository was not before
the District Court. The Receiver had filed no claim in the
bankruptcy Court, and had not submitted to its jurisdic-
tion.

Under these circumstances, District Judge Holt was
of the opinion that he had no power to summon the de-
pository, or its Receiver, before him in a summary way
and require the restoration of the trust funds entrusted
to it. The fact that the Carnegie Trust Company had
even a bond as a depository, which contained an express
covenant that the depository should "abide by all lawful
orders and decrees of the court in and by the premises"
did not, in the opinion of Judge Holt, authorize the sum-
mary proceeding sought to be invoked.

The opinion in *in re Bologh* sets forth the argument presented to the District Court of New York as to the status a depository should occupy in the bankruptcy machinery provided by Congress with great clearness, and we think the opinion is enlightening in this respect.

This decision is also interesting because it emphasizes the rather startling fact that *there appears to be no uniformity about the provisions of depository bonds,—the bond of the LaSalle Street Trust & Savings Bank in the case at bar containing no such provision as we have quoted above from the bond of the Carnegie Trust Company.*

We suggest that this court ought to make provision by general order, for a form of bond required to be given by depositaries.

B.

**FUNDS OF BANKRUPT ESTATES IN DEPOSITORY ARE IN
CUSTODIA LEGIS.**

On the other hand, Mr. Justice Story, in *ex parte Précott*, 2 Gallison's Reports, 145 (19 Fed. Cas. 1283) held that money deposited in a bank under a decree of the court and subject to its order was "money deposited in court," within the meaning of an Act of Congress which provided, among other things, that in all cases of admiralty jurisdiction the Clerk of the District Court should among other fees, be entitled to 1 $\frac{1}{4}$ % on "all money deposited in court."

In that case a ship had been condemned as prize to the captors and from the decree of condemnation the claimants appealed to the Supreme Court. The captors moved the court to order the ship and cargo to be sold and the proceeds to be deposited in the registry of the court and delivered to the captors on bail, and the court ordered the cargo sold under the direction of the marshal at pub-

the auction, and that the "proceeds of the said cargo, after sale, be deposited one-half in the New Hampshire Bank and one-half in the New Hampshire Union Bank in Portsmouth, subject to the order of this court in term, and in vacation to the order of the Associate Justice of the Supreme Court of the United States assigned to the First Circuit."

The cargo (and the ship also) were sold and the proceeds deposited by the marshal in the name of the Court, in the Banks at Portsmouth, according to the order, when the decree of condemnation was affirmed and the proceeds delivered to the prize agent and parties entitled thereto. Thereupon the Clerk of the District Court filed a petition for monition to the prize agents to bring into court, out of the proceeds of the ship and cargo, the amount of commissions due the Clerk.

In his opinion, Mr. Justice Story said:

"The single question presented for decision is, whether the proceeds of the St. Lawrence and cargo were, within the meaning of this clause, 'deposited in court'; if so, then the clerk is entitled to his commission; if otherwise, then his application must be dismissed.

It is argued by the counsel for the prize agents, that the money in this case never was deposited in court, because it never was brought into court, nor actually or constructively in the hands or possession of the clerk."

Continuing, Mr. Justice Story said:

"'Money deposited in court' cannot mean money brought in and deposited *sedente curia*, in the actual manual possession of the court. Such a construction would be against all practice, as well as all legal reasoning. *It must therefore mean money, which is deposited subject to the order of the court, be it in whose actual possession it may, whether of a bank or of an officer of the court.* IN SUCH A CASE, THE BANK OR OFFICER ACTS AS THE MERE FIDUCIARY, OR DEPOSITORY,

OF THE COURT, AND IN LEGAL CONTEMPLATION THE MONEY IS IN THE CUSTODY OF THE COURT. It would be a contempt of the court for any other person to intermeddle therewith. It is a mere substitute for the original property seized under the process of the court, and as much under its sole and exclusive direction, as the property itself. It is emphatically (what all property seized under admiralty process is) in the custody of the law. In this respect, it differs widely from the case of property delivered regularly and bona fide on bail. The latter is no longer subject to the control or custody of the court; and the parties to the stipulation are not the depositaries, but the debtors of the court.

On the whole, I am of opinion, that the money in the present case was, in legal intendment, deposited in court; and, consequently, the clerk was and is entitled to the fees prescribed by law."

This decision by Mr. Justice Story is very enlightening in many respects. For one thing, without specifically purporting to define the meaning of the word "depository," it embodies a definition of that word by defining the legal status and obligations of a depository. In that case, the two banks were not formally designated as depositories either by court order or pursuant to any statute. There was nothing about the deposit to charge the bank with a special responsibility except the name in which the account was opened. There was no bond or undertaking to faithfully keep or account for the moneys, but it will be noticed that Mr. Justice Story goes so far as to say that anyone intermeddling with the money in that account would be punishable for contempt of court.

Most important of all is the holding that these moneys deposited by the marshal were in the custody of the court just as much as though it was in the possession of the clerk.

It would be interesting to know what action Mr. Justice Story would have taken if one of these banks had failed.

One thing is certain: he would *not* have held that the deposit created merely the relation of debtor and creditor.

After the District Court *in re Bologh* refused to exercise summary jurisdiction, the Receivers of these bankrupt estates applied to the Supreme Court of New York for relief, claiming that they were entitled to preference over general creditors. The Supreme Court Trial Division dismissed the complaints, but the Appellate Division, First Department, reversed the orders. *Morris v. Carnegie Trust Co. et al.*, 139 N. Y. Supp. 969.

The Appellate Division held that the Receivers were entitled to priority under Section 189 of the New York State Banking Law, holding that when funds of bankrupt estates are deposited with a depository designated as a Depository in Bankruptcy, they are "moneys brought into court," or "paid into court," and are "*in custodia legis*". The Appellate Division based its reasoning on the decision of Mr. Justice Story in *ex parte Prescott* above referred to.

While this is a decision of a State court administering the assets of a bankrupt trust company, in accordance with the State Banking Law, and held that the preference was given by the Banking Act, nevertheless, *the important and controlling point in the decision is the Court's conclusion that the funds of bankrupt estates deposited by receivers or trustees in a depository designated by the District Court under the Bankruptcy Act, are "brought into court" and are in custodia legis just as much as if the moneys were in the actual custody of the court itself, or its clerk, or any other officer of the court.*

The Court says:

"It seems to me to be quite clear, therefore, that the moneys deposited in the Carnegie Trust Company by the appellants were 'moneys paid into court,' as those words are used in the Banking Law."

And again:

"The words 'moneys paid into court' mean nothing different than moneys which have come by operation of law, in *custodia legis*, and it does not matter, in my opinion, whether the moneys have actually come into the custody of the court itself, or of its clerk, or of any other officer of the court, which trustees and receivers in bankruptcy undoubtedly are."

This decision by the Appellate Division is quite remarkable in one respect. While the District Court of Florida in the United Grocery Co. case, and the Court of Appeals of the Seventh Circuit, in the case at bar (as well as the District Court of New York in the dictum by Judge Holt) all expressed the view that a deposit of funds of bankrupt estates in designated depositories created only the relation of debtor and creditor, *it remained for a State court administering the assets of a defunct bank organized under State Banking Law to adopt the view that such funds in a depository were "moneys brought into court" and were in custodia legis.*

In other words the State Court has put such deposits on a higher plane and given them a more dignified standing than these Federal Courts.

The decision of the Supreme Court, Appellate Division, was reversed by the Court of Appeals of New York but solely on the ground that Section 190 of the New York State Banking Law had reference only to moneys paid or brought into the *State courts of New York* and does not apply to moneys paid or brought into a Federal court.

213 N. Y. 185; 107 N. E. 346.

In *Jones v. Merchants National Bank of Boston*,⁷⁶ Fed. Rep. 683 (35 L. R. A. 698) the Circuit Court of Appeals of the First Circuit had before it a question in relation to two deposits, one of which was in the Merchants National Bank of Boston under standing order by which

that Bank was designated as a depository of all moneys paid into the registry of the Circuit Court of the United States for that district, and the other a deposit in the Boston Safe Deposit & Trust Company, which was not a standing depository of the Circuit Court, but in which a fund was deposited under a special order comprising moneys which had been paid into court.

The court held that a deposit made in a designated depository under Section 995 of the Revised Statutes of the United States

"must be treated as the fund of the court as fully as though it were in the personal possession of the clerk, and therefore, subject in all respects to its summary control and disposition and entitled to protection in all particulars in order that it may be free at all times for such disposition."

The court further said:

"Any interference with it, or with the bank where it is deposited, or attempt thereto, which would embarrass in any degree such control or disposition, or harass the bank, or put it to expense by reason of its possessing the fund, unless the consent of the Circuit Court was first obtained, would amount, on plain principles of law, to an implied contempt, and if persisted in understandingly, to an actual one."

Sections 995 and 996 of the Revised Statutes, as amended by the Act of February 19, 1897, c. 265, Section 3, 29 Stats. 578 (U. S. Compiled Statutes, 1901, page 711, Title 13, Ch. 18 "Judiciary"), are as follows:

"All moneys paid into any court of the United States or received by the officers thereof in any case pending or adjudicated in such court shall be forthwith deposited with the Treasurer, an assistant treasurer, or a designated depository of the United States, in the name and to the credit of such court; provided that nothing herein shall be construed to prevent the delivery of any such money upon security, according to agreement of parties, under the direction of the court.

No money deposited as aforesaid shall be withdrawn except by order of the judge or judges of said courts, respectively, in term or in vacation, to be signed by such judge or judges, and to be entered and certified of record by the clerk; and every such order shall state the cause in or on account of which it is drawn. And it shall be the duty of the judge or judges of said courts, respectively, to cause any moneys deposited as aforesaid, which have remained in the registry of the court unclaimed for ten years or longer, to be deposited in a designated depository of the United States, to the credit of the United States."

Sec. 5504 (18 Stat. 320) :

"Every clerk or other officer of a court of the United States, who fails forthwith to deposit any money belonging in the registry of the court, or hereafter paid into court or received by the officers thereof, with the treasurer, assistant treasurer, or a designated depository of the United States, in the name and to the credit of such court, or who retains or converts to his own use or to the use of another any such money, is guilty of embezzlement, and shall be punished by fine not less than five hundred dollars, and not more than the amount embezzled, or by imprisonment not less than one year nor more than ten years, or by both such fine and imprisonment; but nothing herein shall be held to prevent the delivery of any such money upon security, according to agreement, of parties under the direction of the court."

Sec. 5505 (17 Stat. 2) :

"Every person who knowingly receives, from a clerk or other officer of a court of the United States, any money belonging in the registry of such court as a deposit, loan, or otherwise, is guilty of embezzlement, and shall be punished as prescribed in the preceding section."

According to an opinion rendered by the Attorney-General in 1874 (14 Op., Atty. Gen., 362), Sections 995 and 996 above quoted do not apply to moneys paid into the United States courts or received by officers of such courts

in bankruptcy proceedings. This opinion was rendered before the present Bankruptcy Act of 1898 was enacted. If it is a correct statement of the law, the sections are nevertheless important because *there seems to be no reason why there should be any distinction between the legal status of moneys paid into court and deposited by the clerk in a designated depository under those sections and moneys paid into court or in the possession of an officer of the court and deposited in a designated depository under the Bankruptcy Act.*

It is interesting to note that by these sections, as amended, Congress directs moneys, "paid into any court of the United States or received by its officers" to be deposited either with the Treasurer or a designated depository of the United States "*in the name and to the credit of such court.*"

Curiously enough, the Bankruptcy Act does not provide in whose name or in what manner deposits in designated depositories shall be made.

Section 47a contains a provision that "trustees shall respectively deposit all moneys received by them in one of the designated depositories." This section does not even require the trustee to open the account in his name as *trustee*, or in the name of the bankrupt estate. Quere: Would he be violating the law if he opened the account in his individual name?

Bankruptcy Rule XXIX contains explicit directions as to how moneys may be withdrawn from a depository. "The check must be signed by the clerk of the court, or by a trustee, and *countersigned by the judge of the court*, or by a referee designated for that purpose, or by the clerk or his assistant, under an order made by the judge, stating the date, the sum and the account for which it is drawn," etc., but these wise precautions are of no avail

unless there are also directions as to how and in what name the accounts shall be kept.

It might be well if this court should amend the general orders in bankruptcy to provide that deposits of funds of bankrupt estates should be deposited in an account "in the name and to the credit of the District Court."

In *Osborne v. United States*, 91 U. S. 474, Mr. Justice Field said:

"The power of the court over moneys belonging to its registry continues until they are distributed pursuant to final decrees in the cases in which the moneys are paid. If for any cause they are previously withdrawn from the registry without authority of law, the court can, by summary proceedings, compel their restitution."

In *Corbitt v. The Farmers' Bank of Delaware*, 114 Fed. Rep. 602, after the court had directed, by decree, a check to be drawn in favor of the Farmers' Bank of Delaware on funds to the credit of the court in its registry in the City National Bank of Norfolk, Virginia, an attachment suit was instituted in the State court and the fund sought to be attached.

Waddill, District Judge, said:

"The question presented by the motion to abate the attachment in this cause is whether moneys paid into court pending litigation in regard thereto, and placed by order of the court in its registry or some other designated depository, pursuant to law, are the subject of attachment emanating from another court. This question is one of importance, as it not only affects the orderly administration of justice in the several courts, but goes further, and tends, as in this case, to thwart and annul the carrying out of the court's judgment, in a case fully litigated, with the parties in interest all before it. Money paid into the registry of the court, pursuant to law, can only be withdrawn therefrom by the very terms of the act

of Congress providing for the deposit, 'by the order of the judge, or the judges of said court, respectively, to be signed by such judge, or judges, and to be entered and certified of record by the clerk.' When a court causes funds to be so placed in its registry, they are to the credit of the court itself, there placed and held, to the end that its decrees and orders in respect thereto may be obeyed and carried out in accordance with its judgment rendered; and no court, other than one having a supervisory power over the acts of such court, can by any act of its own, or any decree, order, or process emanating from it, except with its leave, assert any claim to, or secure any right in or lien upon, such funds, so long as the same remain under its control. To entertain a contrary doctrine to this would not only work untold mischief and delay in legal proceedings, but would result in innumerable conflicts between the courts themselves; and the consequence would be that funds once paid into court, with a view of having the rights of parties litigant thereto adjusted and determined, instead of being disposed of by the termination of the particular controversy, would be involved in an endless chain of litigation. This subject has been before the courts, State and Federal, too frequently to now admit of serious cavil or doubt. *Wallace v. McConnell*, 13 Pet. 136, 150, 151, 10 L. Ed. 95; *The Lottawana*, 20 Wall. 201, 22 L. Ed. 259; *Jones v. Bank*, 22 C. C. A. 483, 76 Fed. 683, 686, 687, 35 L. R. A. 698; *In re Forsyth*, (D. C.) 78 Fed. 296, 302-304; *In re Cunningham*, Fed. Cas. No. 3,478; *Tuck v. Manning*, 150 Mass. 211, 22 N. E. 1001, 5 L. R. A. 666; *Curtis v. Ford*, 78 Tex. 262, 14 S. W. 614, 10 L. R. A. 529; *Holker v. Hennessey*, 143 Mo. 80, 44 S. W. 794, 65 Am. St. Rep. 642; *Allen v. Gerard*, 21 R. I. 467, 44 Atl. 592, 49 L. R. A. 351, 79 Am. St. Rep. 816."

In *Thomas v. Chicago, etc., Railroad Co.*, 37 Fed. Rep. 548, District Judge Brown (afterwards Mr. Justice Brown of this court) held that moneys in the hands of a Master in Chancery of the United States Court must be deposited in a depository, in compliance with Sections 995 and 996 Rev. St. U. S., thus holding that such moneys

were in custody of the court, and that the Master is an officer of the United States.

In *Fagan v. Cullen*, 28 Fed. Rep. 843, District Judge Brown held that a marshal who collects moneys upon executions should immediately deposit the same with the clerk or in a designated depository pursuant to the Act above referred to. He held that the clerk is entitled to his commission on said amounts paid to the marshal, so that such moneys were likewise considered by Mr. Justice Brown as moneys paid into court. There would seem to be no good reason why moneys paid to a Master or paid to a marshal, and by them deposited in a designated depository, should be treated as in *custodia legis* any more than moneys so deposited by a receiver or trustee in bankruptcy.

In *First National Bank of Cripple Creek v. Londonderry Mining Co.*, 114 Pae. 313, the Supreme Court of Colorado held that where a fund in controversy and held in a registry of the court was ordered to be deposited, by the clerk, in a bank, the court entering the order had power (without any statute regulating such deposits) to proceed summarily against the depository in the event of its failure to comply with the court's order to repay the moneys. The court said:

"If it is true, as alleged, that there are no statutory provisions regulating or providing for judgment by motion or citation in this class of cases, none are needed. It is a jurisdiction existing and which has been existing from time immemorial."

Of course, we do not contend that moneys deposited pursuant to an order of court in a designated depository become moneys for which the United States would be liable to the parties in the event of the failure of the depository bank, as was contended and expressly denied in *Coudert v. United States*, 175 U. S. 178, 20 Sup. Ct.

Rep. 56. In that case Mr. Justice McKenna called attention to the fact that it is not without significance that when Congress authorized moneys paid into any court of the United States, or received by the officers thereof, in any cause pending or adjudicated in such court, to be deposited with a designated depository, it required it to be done "in the name and to the credit of such court" and not to the credit of the United States.

Act of March 24, 1871 (17 Stats. at Large, 1 Ch. 2)."

The duties and responsibilities of a clerk of a Federal Court with respect to moneys paid into court are defined in *Howe v. United States*, for the use of Stewart, 184 U. S. 676, 22 Sup. Ct. Rep. 543. In that case this court, speaking through Mr. Justice Harlan, after referring to the various Acts of Congress regulating the disposition and custody of moneys paid into court, points out that when a clerk receives moneys paid into court it is his duty to forthwith deposit it either with the Treasurer, assistant treasurer or a designated depository. His responsibility for the money does not cease until he deposits it as required by law.

It thus clearly appears that from the time of the organization of the Federal courts, moneys paid into court were not expected or intended to be retained in the custody of the clerk. On the contrary, he was not only authorized but expected and required to deposit such moneys either with the Treasurer or assistant treasurer or a designated depository of the United States.

When the decisions of the Federal courts with respect to moneys paid into court or deposited with the clerk are considered, it must be borne in mind that these moneys are usually in a bank which has been designated as a depository.

What did the Court of Appeals of the Seventh Circuit mean when it said in this case

"Surely it could not have been intended that, in limiting the number of depositories in which such funds may be placed, there may be incurred, even remotely, the risk of the lawful appropriation of funds, to which normally all creditors are entitled, to the claim of one creditor whose legal or equitable standing was not different from the others, save only in the fortuitous circumstance that the court's officer happened to deposit there funds of the bankrupt estate."

Let us analyze this statement of the Court of Appeals, because to our minds it shows rather a startling point of view. In the first place, it clearly appears that the Court of Appeals considered that it would be unfortunate if funds in the custody of the court, placed in a designated depository pursuant to law, should be treated as trust funds, or on any different basis from an ordinary bank deposit made by an individual; that such trust funds in the custody of the court should be considered on any different basis is a risk which depositories could not be deemed to have incurred "even remotely."

According to this view, there is no sanctity about funds in the custody of a court. They are no different in any respect from ordinary deposits by individuals. Quite a different view from that taken by Mr. Justice Story.

The fact that in this case deposits were made in the bank as a designated depository under the sanction of an act of Congress, had no particular significance. Such deposits are held to be on the same basis as individual deposits "save only in the fortuitous circumstance that the court's officer happened to deposit there funds of the bankrupt estate." Is not this a clear misconception of the nature of the deposits made by a court officer in a designated depository? Under these circumstances, can

it be said that when the trustees deposit funds of bankrupt estates in a designated depository, their deposit is only a "fortuitous circumstance" and that the court officer merely "happened to deposit there funds of the bankrupt estate?" It seems to us, under the circumstances, it is neither a fortuitous circumstance nor did the officer merely "happen" to deposit there the funds of the bankrupt estate.

The court's officer had no discretion in the matter. *He was compelled by law and the court's order to deposit the funds in a designated depository, and nowhere else.* Section 47a of the Bankruptcy Act required trustees to "deposit all money received by them in one of the designated depositories." The Section uses the word "shall," which is mandatory and has been so held. *Huttig Mfg. Co. v. Edwards*, 160 Fed. Rep. 619; 87 C. C. A. 521.

To say that when an officer deposits funds in a particular bank under a requirement of an act of Congress and a court order it is only a "fortuitous circumstance" that he "happened" to do so seems a queer conception of the significance of his acts.

The Circuit Court of Appeals evidently contemplated with alarm that there should be "incurred even remotely, the risk of" regarding trust funds in the custody of the court as entitled to any more consideration than commercial deposits by individuals or corporations.

Manifestly, this view would not only completely destroy the significance of the acts of Congress in relation to depositories under the Bankruptcy Act, but if it is sound it must also be held to apply equally to other funds in the custody of Federal courts deposited by the clerk or by a marshal in designated depositories under Sections 995 and 996 of the Act of 1871 above referred to. There can be no possible difference between the legal status of

funds paid into court and deposited by the clerk in a designated depository, under Sections 995 and 996, and funds deposited by a receiver or trustee in bankruptcy in a designated depository under Section 61 of the Bankruptcy Act. Both are court officers, and both funds are in *custodia legis*, subject to the order, decree or final disposition of the District Court.

As we have already pointed out, the policy declared by the State of New York in its banking law, is that moneys "brought into court" or "paid into court" and deposited in a designated state depository, are entitled to priority and preference in the administration of the funds of insolvent trust companies. Here is a declaration of policy by a State legislature that such funds are sacred, and must be protected at all costs. Mr. Chief Justice Waite, in *Branch v. United States*, 100 U. S. 673, referred to such moneys in the custody of a Federal court as money belonging to the court and held as a trust fund, saying:

"In this case the money deposited belonged, for the time being, to the court, and was held as a trust fund pending the litigation."

In that case the fund in the custody of the court had been deposited by the clerk in a public depository designated by the Secretary of the Treasury, and it should be borne in mind that at that time Sections 995 and 996 had not been enacted.

When an individual or a corporation deposits its funds in a bank, he or it does so of his or its own volition. They are not controlled in any way. Such individual or corporation can select any bank he or it chooses from all the list of banks available. If the individual or corporation selects a weak bank, or one that is unsound and becomes insolvent, he has no one but himself to blame. He has entrusted his moneys to that bank upon its credit for reasons satisfactory to himself.

Not so with a court officer. *The court officer does not deposit the trust funds in his possession in a designated depository because he believes it to be the best and safest bank; on the contrary, he may be of the opinion that the bank is unsafe, but he has no alternative.* He is compelled to deposit the funds in that bank because the provisions of the law and the order of the court require him to do so, and hold him responsible if he does not do so.

Under these circumstances, his act in entrusting funds in his custody as a court officer to the bank so designated can, by no stretch of the imagination, be deemed "a fortuitous circumstance," nor can it be said that he merely "happened" to deposit there the funds entrusted to his custody as a court officer. *If the bank fails and becomes insolvent, the responsibility is not his, but the responsibility rests upon the court that designated the depository.*

Among the many acts of Congress dealing with depositories is the Act of March 3, 1857, which makes a public depository guilty of the crime of embezzlement if it "fails safely to keep all moneys deposited" with it. It is subject not only to a penalty of imprisonment of not less than six months nor more than ten years, but "may be fined in a sum equal to the amount of money so embezzled."

Assuming, for the sake of argument, that the Act of March 3, 1857 (11 Stats. at Large 249), (U. S. Compiled Stats. Vol. 3, Sec. 5489) applies only to "moneys of the United States" and not to trust funds belonging to or in the possession or custody of a court, is there any good reason why Congress should have determined that a public depository is guilty of embezzlement which fails to safely keep moneys of the United States, while a public depository designated by law for the deposit of funds in the custody of a court may with impunity fail safely to keep moneys deposited with it without incurring any risk

whatever because the moneys had been merely "loaned" to the depository by the court's officer, and hence no different from ordinary deposits by individuals or corporations? The Act of March 24, 1871 (17 Stats. at Large 1), (3 U. S. Comp. Stats. 1901, p. 3711) provides that any one who receives from a court officer of the United States any money belonging in the registry of such court *as loan, is guilty of embezzlement.*

Is there any refinement of reasoning by which the clerk or other court officer having funds of the court in his custody may lawfully "loan" such funds to a bank (if designated as a depository), but may not "loan" such funds to any one else without being guilty of embezzlement? There is no proviso or qualification in the Act of March 24, 1871, which makes it lawful for the court officer to "loan" funds in his custody even to a designated depository, and, *Quere*, if he deposits those funds in a designated depository as an ordinary deposit, merely creating the relation of debtor and creditor, what has he done except to "loan" the funds to the bank.

It seems clear that it was never contemplated by Congress that funds belonging to a court, or in its custody, should be subjected to any greater hazard of loss when deposited in a depository pursuant to the Act of Congress than moneys of the United States when so deposited. Otherwise, why should such court funds be required by Congress to be deposited *either* with the treasurer, or an *assistant treasurer, or a designated depository.*

No one would for a moment contend that the treasurer, or assistant treasurer, received court funds deposited by a court officer on the basis of a bank deposit, and we are unable to perceive anything in the Act of March 24, 1871 (17 Stats. 1) differentiating between the character of a deposit of such funds when made with the treasurer or

assistant treasurer and those deposited in a "designated depository" of the United States "in the name and to the credit of such court." Congress clearly was of the belief that funds in the custody of a court deposited with a designated depository of the United States were on no different basis and were just as safe as though deposited with the treasurer or assistant treasurer. Of course, if deposited with the treasurer or assistant treasurer, the Government would be responsible for their loss, while if deposited in a designated depository the Government is not liable (*Coudert v. United States*, 175 U. S. 178), but that does not mean that a "designated depository of the United States" receives such funds belonging to the court and deposited "in the name and to the credit of such court" on the same basis as deposits of individuals or corporations in commercial accounts.

To return therefore, we think it is manifest that the view expressed by the Court of Appeals of the Seventh Circuit is erroneous, and that moneys deposited in a designated depository by the clerk of a Federal court, or other Federal court officer, whether under the Act of March 24, 1871, or under the provisions of the Bankruptcy Act, cannot be considered as on the same basis as commercial deposits, in the bank acting as a designated depository, without absolutely nullifying the spirit and intent of the provisions of the acts of Congress providing for the deposit of funds in the custody of an officer of a Federal court in designated depositories.

If the view of the Circuit Court of Appeals of the Seventh Circuit, that such deposits of court funds by a court officer, are on the same basis as ordinary deposits and create only the relation of debtor and creditor, what becomes of the doctrine announced by many Federal and State courts, that funds in the custody of the court are

not subject to garnishment or attachment, and can not be made answerable to any other court in any other suit? What becomes of the doctrine laid down by Mr. Justice Story, that "it would be a contempt of the court for any other person to intermeddle therewith?" What becomes of the provisions of the Bankruptcy Rule 29, that moneys in the depository can only be drawn on a check signed by the clerk or a trustee, and countersigned by the judge or referee?

The view of the Circuit Court of Appeals of the First Circuit (*Jones v. Merchants National Bank*, 76 Fed. Rep. 683) is that:

"Any interference with it, or with the bank where it is deposited, or attempt thereto, which would embarrass in any degree such control or disposition, or harass the bank, or put it to expense by reason of its possessing the fund, unless the consent of the Circuit Court was first obtained, would amount, on plain principles of law, to an implied contempt, and if persisted in understandingly, to an actual one."

How can these views be harmonized with the views of the Circuit Court of Appeals of the Seventh Circuit, that such deposits create merely the relation of debtor and creditor. If the view of the Court of Appeals of the Seventh Circuit is correct, the bank (depository) *merely owes* the money to the court officer. If that is the correct and legal relation, what is to prevent the attachment or garnishment of moneys supposed to be in the depository and which have, in reality, merely been loaned to the bank? The question appears to answer itself. It is impossible to harmonize the views expressed in these cases, and it seems to us clear that the view expressed by the Circuit Court of Appeals of the Seventh Circuit in the case at bar is erroneous and must give way.

II.

BANKRUPTCY COURTS ARE COURTS OF EQUITY AND SHOULD BE GOVERNED BY EQUITABLE PRINCIPLES.

A court of bankruptey has unlimited jurisdiction in respect of its powers over proceedings in bankruptey.

Sabin v. Larkin-Green Co., 218 Fed. 984.

A proceeding in bankruptey is an equitable proceeding, and the court has all the inherent powers of a court of equity to enforce and protect its jurisdiction.

In re Swofford Bros. Dry Goods Co., 180 Fed. 549.

A bankruptey court has the plenary powers of a court of equity, and can exercise the powers of such a court for the ascertainment and enforcement of the rights and interests of the various parties interested in the estate of the bankrupt company.

Bardes v. Hawarden Bank, 178 U. S. 524; 20 Sup. Ct. Rep. 1000.

Dodge v. Norlin, 133 Fed. 363.

In re Siegel-Hillman's Dry Goods Co., 111 Fed. 980.

In dealing with partnership matters, a court of bankruptey is vested with full equity powers.

In re Filmar, 177 Fed. 170.

In determining an issue of fraud, a court of bankruptey is governed by the rules of courts of equity.

In re Hawks, 204 Fed. 309.

An adjustment of equities between creditors arising out of the provisions of the Bankruptey Act is peculiarly within the rule governing bankruptey powers.

In re Siegel-Hillman Dry Goods Co., 111 Fed. 980.

In 7 C. J. 27, it is said:

"The administration and distribution of the property of a bankrupt is a proceeding in equity, and when authorized by Act of Congress it becomes a branch of equity jurisprudence. Accordingly a District Court sitting in bankruptcy can exercise the full powers of a court of equity for the ascertainment and enforcement of the rights and equities of the various parties interested in the bankrupt estate."

Citing—

Bardes v. Hawarden, etc., Bank, 178 U. S. 524; 20 Sup. Ct. Rep. 1000.

In re Gillaspie, 190 Fed. 88.

In re Swofford Bros. Dry Goods Co., 180 Fed. 549.

Mason v. Wolkowich, 150 Fed. 699; 10 L. Rep. Ann. N. S. 765.

In re Rochford, 124 Fed. 182.

Swarts v. Siegel, 117 Fed. 13.

III.

(a) "HE WHO SEEKS EQUITY SHOULD DO EQUITY." "HE WHO COMES INTO EQUITY SHOULD DO SO WITH CLEAN HANDS."

(b) THE CIRCUIT COURT OF APPEALS BASED ITS DECISION UPON THE TECHNICAL RULES OF SET-OFF.

THE OFFICIAL RELATION OF TRUST OF THE DEPOSITORY TO THE BANKRUPT ESTATE AND THE BREACH OF THAT TRUST BY THE DEPOSITORY, WERE NOT CONSIDERED AS AFFECTING THE STATUS OF THE CLAIM OF THE DEPOSITORY NOR TO JUSTIFY THE DISTRICT COURT IN IMPOSING CONDITIONS TO PREVENT ITS PARTICIPATION IN THE ASSETS OF THE BANKRUPT ESTATE UNTIL IT HAD MADE RESTORATION OF THE MISAPPROPRIATED FUND OF THE ESTATE.

(c) ITS DECISION PERMITS THE DEPOSITORY WHICH HAS BREACHED ITS TRUST TO ASSERT ITS CLAIM AGAINST THE BANKRUPT ESTATE AND PARTICIPATE IN THE REMAINING ASSETS WITHOUT REQUIRING IT TO MAKE RESTORATION EVEN TO THE EXTENT OF ALLOWING THE COUNTER CLAIM

OF THE BANKRUPT ESTATE FOR THE TRUST FUNDS OF THE ESTATE WHICH WERE CONVERTED BY THE DEPOSITORY TO BE SET-OFF AGAINST THE CLAIM OF THE DEPOSITORY.

- (d) THE EFFECT OF THEIR DECISION IS THAT THE RECEIVER OF THE ERRANT DEPOSITORY WILL BE PAID ITS CLAIM IN FULL WHILE THE BANKRUPT ESTATE WHICH HAS SUFFERED THROUGH THE DEPOSITORY'S BREACH OF TRUST WILL RECEIVE LESS THAN FIFTY PER CENT OF ITS COUNTER CLAIM. WE BELIEVE THIS IS BOTH LEGALLY AND MORALLY WRONG.
- (e) SUCH A RECREANT OFFICER SHOULD NOT BE PERMITTED TO ASSERT A CLAIM IN THE COURT THAT APPOINTED IT AGAINST THE REMNANT OF THE VERY ESTATE IT HAS LOOTED AT LEAST NOT UNTIL IT HAS MADE RESTORATION OF THE MISAPPROPRIATED FUNDS, NOR SHOULD THAT RESTORATION (WHERE THE CIRCUMSTANCES PERMIT IT TO BE WORKED OUT THROUGH THE MEDIUM OF A SET-OFF) BE MADE CONDITIONAL UPON WHETHER THERE WOULD BE A TECHNICAL RIGHT OF SET-OFF IF THE CASE WERE AN ORDINARY ACTION AT LAW, i. e., WHETHER THERE IS STRICT MUTUALITY.

Of course, the situation in the case at bar is much stronger than in *in re Bologh* or in *Morris v. Carnegie Trust Co.* The question in this case is *not* whether the Trustee's deposit is entitled to priority nor whether its payment, as in this case, would create a preference not justified by the Illinois Banking Law.

The District Court in this proceeding was not administering the affairs of the LaSalle Street Trust & Savings Bank, and is not attempting to decide or determine the rights of creditors under the Illinois Banking Law. The situation is an entirely different one. The Court of Bankruptcy is administering the bankrupt estates entrusted to its care. It had previously appointed the LaSalle Street Trust & Savings Bank a depository, and therefore, a special relationship existed between the court and the depository and the depository by that appointment became an officer or a quasi officer of the Court. Under

these circumstances, if the Bank had not gone into the hands of a Receiver but had itself filed its claim with the District Court and at the same time refused to account to the Court for the funds of the bankrupt estate deposited with it by the Trustees, what would the Court have done?

When the Receiver voluntarily came into the District Court *and invoked its aid to pay a claim due the depository*, without offering to restore the funds the depository had misappropriated the District Court had the opportunity presented to it (which the District Judge, as well as the Referee did not hesitate to take advantage of) of dealing out justice to its depository without the trouble of instituting proceedings, summary or otherwise.

The fact that a Receiver had been appointed for the depository does not change the situation. The Receiver of a corporation in Illinois has no greater rights than the corporation itself. (*re Public Life Insurance Co. v. Swigert*, 135 Ill. 150.) The Receiver stands in the shoes of the depository. The District Court thereby acquired jurisdiction of the person of the Receiver, and, of course, of the subject matter (the claim), and should, it seems to us, have the right to deal with the claim by the application of equitable principles.

The principle that "He who seeks equity must do equity" unquestionably warranted the Bankruptcy Court (which is a Court of equity) in imposing, as a condition precedent to the allowance of the claim of the depository (or its Receiver) the restoration of the funds of the bankrupt estate which the depository had wrongfully converted. Whatever the right or power of the District Court may have been to reach out and bring in the Receiver against his protest, it is not necessary to decide in this case. The Receiver came into the District Court voluntarily and submitted to its jurisdiction (in re

Harper, 175 Fed. Rep. 412), and having done so, the subject matter of the claim and the whole relationship of the depository to the bankrupt estate was before the District Court for determination even if it be conceded that the District Court was helpless, and had no power to bring its Depository before it in a summary way (a proposition we would *not* concede). To say that under such circumstances the District Court is powerless to deal with its own depository appointed by its own order, and must pay out the funds of the very estate which the depository has misappropriated without having the right to require the depository to make restoration, creates a situation which shocks the sense of a layman and ought to shock the conscience of a Chancellor whose conscience is supposed to be more enlightened and more accustomed to recognizing equities.

That a Court of Bankruptcy administers its estates in accordance with equitable principles and is in reality a court of equity, is too well settled to be controverted. The Circuit Court of Appeals exercises a power to a review, which is intended to be controlled by equitable principles. In fact, courts of bankruptcy are in reality courts of equity.

We venture to assert that if the depository (or its Receiver) had filed this claim against the estate of the O'Gara Coal Company, and it had developed upon the hearing of its claim that it had misappropriated the funds of some other bankrupt estate or a number of bankrupt estates, the District Court had the power (or ought to have the power if it has not) to say to the depository (or its Receiver),—"This Court will not entertain your claim against the bankrupt estate of the O'Gara Coal Company so long as you are in default as a depository of this Court, and until you make restoration of the funds of all the other estates which you have misappropriated

this Court will not recognize you as a claimant in any bankrupt estate which this court is administering." Is there any improper exercise of power in a situation of that kind? To say that such an order would be an abuse of power is to hold virtually, and to all intents and purposes, that the appointment of a depository has no particular significance, that the depository is not an officer of the court, nor is it subject to the order or direction of the court; in fact, the whole proceeding in which it is appointed is more or less farcical. It means that the depository is not a part of the machinery of the Bankruptcy Act for the administration of bankrupt estates under the supervision of the court.

What would a Bankruptcy Court do if a receiver or a trustee misappropriated funds of the bankrupt estate? Would it hesitate to punish it or to impose conditions if the defaulting officer of the court had the temerity to appear in court and ask the aid of the court to collect a debt due the defaulting officer? Would the court not feel that it was adding insult to injury if a defaulting receiver came into the bankruptcy court and asked it to allow his claim against the bankrupt estate for compensation or otherwise, when he had misappropriated part of the funds of that very estate, without offering or requiring him to make restoration? It is such an elementary proposition that it does not appear to require any extended argument. Either the depository is an officer of the court or the appointment has no significance whatever. In that event, the provisions of the Bankruptcy Act might as well be disregarded. If the only effect of those provisions is to obtain a bond from the bank, it is apparent they fall short of safeguarding the funds of bankrupt estates. While the Bankruptcy Act authorizes the District Courts to increase the bond of the depository from time to time, such bonds are never sufficient to

cover the amount of the deposits. Take for instance the case at bar. The bond of the depository was \$50,000, only a small fraction of the funds of bankrupt estates entrusted to it. It was so small in proportion to the amount of bankrupt funds deposited that the amount it would yield hardly justified the expense of enforcing the claim.

But to return to the relation occupied by the depository toward the court. Without regard to the question whether courts which are charged with the administration of bankrupt estates can protect the funds of bankrupt estate entrusted to their care by punishing a depository that has betrayed its trust, is it possible that it is helpless when the depository actually asserts a claim against the same estate, the court must sit with its hands tied *and pay out the remainder of the funds looted estate to the depository*, without having the power to require it to restore what it has already wrongfully taken.

While the order of the Referee in this case was in the form of a set-off, its effect is precisely the same as though the court had said to the depository,—“I will allow your claim upon condition that you restore the funds you have already taken and failed to account for.”

If the court is powerless to impose this condition, whether in the form of a set-off or otherwise, the legal effect is that the depository can say to the court “I insist that I be paid the full amount of my claim without regard to my previous wrongdoing, and I will not credit (and the court cannot compel me to credit) upon my claim the moneys which the court has entrusted to me, belonging to the estate, and which I have misappropriated.”

Stated differently, the respondent says “I am going to keep what I got (wrongfully) and the court cannot take it away from me; in fact, the court cannot touch it, al-

though I am a court officer, *but I insist the court pay me what the court owes me, notwithstanding my wrongful acts toward the court and toward its estates.*"

To deal with that situation upon the basis of the principle of legal set-off, as the Court of Appeals in this case, and say that the order is erroneous merely because the depository could not have paid itself the amount of its claim out of the funds of the bankrupt estate seems to us so superficial that it is startling. THE DECISION OF THE COURT OF APPEALS EFFECTS A RESULT WHICH IS PERPETUATING A WRONG INSTEAD OF RIGHTING IT.

Any course of reasoning by which the conclusion is reached that the Court of Bankruptcy is obligated to pay the insolvent depository's receiver the amount of its claim out of the funds of the bankrupt estate, without the right to require the depository (or its receiver) to restore to the bankrupt estate the funds it had misappropriated, seems not only thoroughly unsound, but both legally and morally wrong. Any moneys that may be paid on account of the claim of the depository, filed in the bankruptcy proceedings, will come out of the bankrupt estate (and thus further deplete it) and go into the insolvent estate of the depository.

On the other hand, any moneys which may be paid on the deposits by the Trustee in Bankruptcy (which belong to the bankrupt estate) will be paid out of the insolvent estate of the depository and go into the bankrupt estate. If mutuality is to be the controlling principle in a situation of this kind (merely because the Court's order deals with it through the medium of a set-off, which is purely a means to an end) it seems to us that there is actual mutuality, but we must urgently insist that it is not a situation which should be dealt with purely from the standpoint of principles governing an ordinary set-off at law.

To deal with it on that basis is to ignore the real purpose of the order which is to right the wrong done to the bankrupt estate, not by punishing the offender but by applying equitable principles as a condition to grant relief to the offender. If the depository were an individual, he could probably be punished criminally for the act of converting the trust funds of the bankrupt estate. The depository being a corporation, cannot be punished in that way, but through the fortuitous circumstance of its having a claim against the bankrupt estate, the Court of Bankruptcy, when it comes in to ask payment of its claim, is in the position of being able not to punish it but to apply the equitable principle, "He who seeks equity must do equity" by requiring the claimant to restore what it has wrongfully taken.

This is the proper aspect in which the order of the District Court should be viewed. Courts of equity are in the habit of disregarding form and looking to the substance, —the end to be accomplished.

The order of the District Court meets that test. It accomplishes the ends of justice. IT IS RIGHT IN EVERY RESPECT, and to set it aside (as the Circuit Court of Appeals has done in this case) is to perpetuate a wrong which can never be righted in any forum.

To deal with it in accordance with the rules of set-off, by the application of the principle of mutuality, is, it seems to us, a most unfortunately narrow view, *the effect of which is to not only entirely ignore (and thus condone) the criminal act of the depository, but to actually reward the wrongdoer by permitting it to take more of the same estate without giving up what it has already taken wrongfully!*

THIS CASE AFFORDS AN OPPORTUNITY TO THIS COURT TO SET-TLE FOR ALL TIME THE QUESTION OF THE STATUS, DUTIES AND

RESPONSIBILITIES OF THE DEPOSITORIES UNDER THE BANKRUPTCY ACT, AND THEIR RELATIONS TO THE COURT, AND THE COURT'S POWER (OR LACK OF POWER) TO DEAL WITH THEM.

IT IS IMPORTANT IN ORDER TO SECURE A UNIFORM AND ORDERLY ADMINISTRATION OF THE BANKRUPTCY ACT THAT THIS BE DONE.

It is bad enough under any circumstances to contemplate the loss of the funds of bankrupt estates through the failure of depositories. The provision for depository bonds is entirely inadequate, the amount of the funds of bankrupt estates on deposit being always many times the amount of the depository bond. *Therefore, the responsibilities of the depository should be determined and the power of the Court to deal with the depository should be settled.*

In this case, however, the intolerable situation arose of a depository, after having misappropriated the funds of hundreds of bankrupt estates, having the impertinence to apply to the court that appointed it to share in the remaining assets of one of those estates without being required to make restoration of what it had already taken, even from the very estate against which it was asserting the claim. It is hard to imagine a situation more elementally wrong than that created by the order of the Court of Appeals in this case, which tied the hands of the District Court and prevented it from dealing in any manner with the depository while at the same time it requires that court to hand over to the defaulting depository the remainder of the funds of the bankrupt estates to the extent necessary to pay a prior obligation of the bankrupt.

As we have already said, the situation is so intolerable that it shocks the conscience of a layman, and it seems rather ridiculous to have to present an argument to the highest court of the land to demonstrate that the order

ntered by District Judge Carpenter was not only right under the circumstances, but was the only order a self respecting court should consider, in dealing with a re-re-
ant Depository.

IV.

N EQUITY, MUTUALITY IS NOT ESSENTIAL TO A SET-OFF, BUT IN THIS CASE THERE IS ACTUAL AND EQUITABLE MUTUALITY.

In the Circuit Court of Appeals respondent relied largely, if not solely, on the case of *In Re United Grocery Co.*, 253 Fed. 267, decided by the District Court for the Southern District of Florida.

This decision, without binding force upon this court, is, as we shall endeavor to show, fundamentally erroneous.

The decision is predicated upon the proposition of the want of mutuality, which the court held to be conclusive of the question before the court.

In this we contend the court erred; first, because under the circumstances of the case at bar, the deposits of the moneys of the O'Gara Coal Company, bankrupt, in the bank may be applied as in the nature of a credit or payment upon the claim of the bank against the O'Gara Coal Company, for the reasons fully and conclusively set forth in *People v. California Safe Deposit & Trust Co.*, 141 Pac. (Cal.) 1181, and the other cases cited by us; and, second, because in any event mutuality is not necessary in cases where the equitable jurisdiction of the court is called into action, or, in other words, in so-called cases of equitable set-off arising from the insolvency of the party against whom the set-off is sought to be made, as in this instance, the bank.

In the case at bar, the real parties in interest are the

bankrupt estate on the one side, and the insolvent estate on the other. Originally, the real parties in interest were the bankrupt corporation on the one side, and the bank on the other. Upon the insolvency of the bank, their respective estates became the real parties in interest. The trustee of the bankrupt estate on the one hand, and the receiver of the insolvent estate on the other, are mere nominal parties, with no actual personal interest. Any moneys that may be paid on account of the claim of the bank in the bankruptcy proceedings will come out of the bankrupt estate, and go into the insolvent estate of the bank. Any moneys that may be paid on the deposits by the trustees in bankruptcy in the bank (consisting of assets and funds of the bankrupt estate) will, on the other hand, be paid out of the insolvent estate of the bank and go into the same bankrupt estate.

There is here, then, actual and equitable mutuality.

As was said in *People v. California Safe Deposit & Trust Co., supra*, where an insolvent bank was asserting its claim for payment against the estate of a decedent, and the administrator was insisting that deposits of the estate's moneys made by him with the bank after the death of the deceased, should be applied upon the claim of the bank:

"While the respective demands may not be strictly mutual, they are very intimately connected; the claimant in effect owes the estate, and the estate owes him; both demands had relation to funds of the estate. This presents a situation where, in the interests of clear right and justice, an exception to the general rule of mutuality shall be applied and a set-off allowed."

The bank is in this bankrupt estate insisting upon its right to be paid in full out of the funds of the estate. On the other hand, with funds of the estate in its pocket, deposited with it by the trustees in bankruptcy, it is also

insisting that no part of these funds should be applied upon its claim, but that the bankrupt estate should go into its insolvency proceedings to get what it can of the funds of the bankrupt estate received and still held by it. This is, we contend, a shocking and intolerable attitude. We cannot believe that this court, having in its hands the administration of the assets of the bankrupt estate in the interests of the creditors and the bankrupt, will pay a creditor a hundred cents on the dollar out of the funds of the bankrupt estate, permit the creditor to retain, without deduction or application, funds of the estate received by him, and send the bankrupt out of its court to get what it may of these funds out of the insolvent estate of the creditor in another proceeding and court.

In principle, the rule that an executor or administrator has the right to retain the whole or a part of a legacy in discharge of a debt due from the legatee to the estate is applicable here, and, as was said in *Smith v. Kearney*, 2 Barb. Ch. (N. Y.) 533, 549:

“The right to retain depended upon the principle that the legatee or distributee was not entitled to his legacy or distributive share, while he retained in his own hands a part of the fund out of which that and other legacies or distributive shares ought to be paid, or which were necessary to extinguish other claims on that fund. In other words, the legatee or distributee in such cases, seeks to obtain a portion of the fund which the testator or the letters of administration have placed in the hands of the executor or administrator to pay debts, legacies or distributive shares; while such legatee or distributee is himself debtor to the estate, and by withholding payment, diminishes the fund to that extent; and *it is against conscience that he should receive anything out of the fund without deducting therefrom the amount of that fund which is already in his hands, as a debtor to the estate.*”

And as was said in *Porter v. Roseman*, 74 N. E. 1105:

"It is certainly unconscientious for an insolvent party to coerce the payment of his claim when he is owing the other party an equal or a larger sum, and thus leave the latter remediless."

In *Re Bell's Estate*, 141 Pac. (Cal.) 1179, the court said:

"We are satisfied that the Superior Court, sitting in probate, had the jurisdiction to entertain the defense of set-off interposed by the administratrix. It had jurisdiction of the estate of Bell and over all proceedings therein, which included a determination of whether the bank was entitled to the order for payment of its allowed claim. It had jurisdiction of the parties in that particular proceeding and over the subject-matter."

In Re Harper, 175 Fed. 412, the court says, at page 426:

"If such a claim for damages is not regarded as the subject of set-off within the meaning of Section 68a, the trustee here must go to a foreign state and bring suit, and take his chances of making collection in case of recovery.

In either case that claimant company is in this court seeking a dividend from the estate, and it seems clear to me that under the general policy, and to answer the true purpose of the law, the claim of the trustee is to be regarded and treated as an alleged debt of that company to the estate in bankruptcy, and if established off-set or counter-claimed."

And so also in *Siegel-Hillman Dry Goods Co.*, 111 Fed. at page 986, the court says:

"The ruling in this case justifies the holding that in cases wherein a court of equity is charged with the distribution of an estate or a fund under its control, and has before it the several parties whose rights and interests are involved in the administration of the estate, it may, disregarding mere matters of form, but having regard to the substantial rights of all the parties, ascertain the ultimate relation and liability of the several parties, and base its decree

thereon, thus avoiding the delay and expense which would be caused if the parties were remitted to the pursuit of their legal rights without aid of a court of equity."

Similarly, in *North Chicago Rolling Mills Company v. St. Louis Ore Company*, 14 Sup. Ct. Rep. 716, the court adds:

"The adjustment of demands by counter-claim or set-off, rather than by independent suit, is favored and encouraged by the law to avoid circuituity of action and injustice."

In *Lindsay v. Jackson*, 2 Paige's Ch. (N. Y.) 580, the court said:

"A complainant ought not to be left to pursue his legal remedy against his defendants when, from their insolvency no satisfaction of his demands could be thus obtained."

In *Porter v. Roseman*, 74 N. E. (Ind.) 1105, the court, quoting from Barbour on Set-Off, says:

"If a court finds a case of natural equity not within the statute, it will permit an equitable set-off, if, from the nature of the claim, or from the situation of the parties, it is impossible to obtain justice by a cross-action."

In the well-considered case of *People v. California Safe Deposit & Trust Company*, 141 Pac. (Cal.) 1181, the court says at page 1183:

"The only effect of denying the right of set-off to the administrator in this situation would be to compel him to sue to enforce payment from the creditor if he was solvent, and this for the sole purpose of thereupon paying it back to him in satisfaction of his claim. This would be an idle and senseless thing to require a court to do. ***"

The denying of the right of set-off under these circumstances simply for want of mutuality would be not only unjust and oppressive towards the creditors, but also an idle and absurd act."

In Receivers v. Paterson Gas Light Company, 23 X. J. Law, 283, 294, the court says:

"And there is no equality and no equity in putting a debtor of the bank, who had a just and legal set-off, as against the corporation, in a worse position, and the creditor in a better position by the failure of the bank and the appointment of receivers."

When the creditor invokes the aid of this court and seeks payment of his claim, this court will see to it that the moneys of the estate which the creditor has already received shall be applied in payment so far as necessary upon the claim asserted. *It will not permit the creditor to get funds of the estate twice*, which would be the situation if the receiver were permitted to prevail in the proceeding.

The law is, as the authorities hereafter cited by us clearly show, that set-off is not strictly a defense, but regarded as in the nature of payment to be applied by the court.

34 Cye. 644.

As was also said in *Porter v. Roseman*, 74 N. E. 1105:

"In enforcing an equitable set-off, the court proceeds upon the principle that one demand is *pro tanto* a satisfaction of the other, *and that the real indebtedness is merely the balance.*"

Other cases will be cited by us to the same effect.

In *Chandler v. Drew*, 6 N. H. 469; 26 Am. Dec. 704, it is said, on page 707:

"Strictly speaking, a set-off is not a defense. When a set-off is made, mutual claims, to an equal amount on each side, become, under the statute, a satisfaction of each other. They operate as a payment to each other. When the claim of the plaintiff is wholly paid by a set-off, the action is at an end, and he may not be liable to costs. But his claim has not been defeated by a defense, but has been paid by the extinction of another claim."

guishment of claims against him, to an equal amount. And, with the exception of the cases to which we have just adverted, no case has occurred to us in which a set-off has ever been considered as a defense, within the meaning of the rule, on which the decisions in those cases rest."

The bank has once been paid out of the funds of the bankrupt estate to the extent of the deposits of the moneys of the bankrupt estate received by it.

As a matter of fact, the rights of the parties are mutual and reciprocal, as is shown by *People v. California Safe Deposit & Trust Company, supra*.

Suppose the bank had not become solvent and had come into the bankrupt estate for an order to require the trustee to pay its proved claim, can there be any doubt that the trustees would have had the right to deduct from the claim or apply upon it the deposits which the trustee had made in the bank? The trustee would clearly have had this right.

As in the case of *People v. California Safe Deposit & Trust Co., supra*, the many other cases cited by us hereafter show this right on the part of the trustee was not affected or taken away by the insolvency of the bank, but continued to exist, since it is settled that the receiver stands merely in the shoes of the bank, and takes subject to all equities against it.

It is, of course, well settled that when a bank becomes insolvent, its depositor may avail himself in set-off against his indebtedness to the bank of any indebtedness of the bank to himself, as, for example, the balance due him on his deposit account.

Morse on Banks (4th Ed.), Par. 338, and cases cited.

On the other hand, when the bankrupt estate became solvent and able to pay one hundred cents on the dollar

to its creditors, the bank, and upon its solvency, its receiver, had a reciprocal right to set off its allowed claim against the bankrupt estate in any suit or proceeding brought against it to recover the debt due the bankrupt estate, or its trustee, on account of the deposits of the moneys of the bankrupt estate in the bank, such debt therefore, representing assets of the estate. This was squarely held in *People v. California Safe Deposit & Trust Co., supra*, and for reasons therein set forth, to which repetition we call the court's attention.

In the present circumstances of this case, therefore which are now, at the time payment by the bank is demanded, controlling, we insist that the bankrupt estate having become solvent, all necessary mutuality and reciprocal rights exist, as we have pointed out.

The court *In re United Grocery Co.*, we contend, therefore, was in error in saying that neither the bank nor its receiver could have applied the deposit to the payment of the debt owed the bank by the bankrupt, nor the trustee of the bankrupt apply the deposit to the discharge *pro tanto* of the debt of the bank.

But even if this were so, it is not determinative because any such want of mutuality became immaterial upon the insolvency of the bank, giving rise to an equitable set-off whether mutuality existed or not, as we shall hereafter fully show. This element the court wholly overlooked.

But beyond these considerations, and without reference to them, the insolvency of the bank gave rise to the right to invoke the equitable jurisdiction of this court, in which the court's action is not limited by technical legal rules and in which the court disregards the form and looks to the substance, and will grant relief notwithstanding want of mutuality, and a difference in the capacity of the parties, so long as the same substantive rights and interests are to be affected.

The cases cited by us will fully sustain this contention. Thus, in *People v. California Safe Deposit & Trust Co., supra*, the court, among other things, said:

"The creditor may be insolvent, and it is well settled that the insolvency of a party against whom a set-off is claimed constitutes a sufficient ground for the allowance of a set-off not otherwise available."

A court of equity is concerned with actual mutuality and not with technical legal mutuality, whenever the circumstances, such as insolvency, give rise to its intervention.

As was said in *Brewer v. Norcross*, 17 N. J. Eq. 219, 225:

"They (courts of equity) look beyond the form of the contract to its real character, and beyond the nominal parties to the parties to be affected by the decree."

In Waterman on Set-Off, Par. 218, it is said:

"By mutual debts between the parties is meant the real and not merely the nominal plaintiff and defendant."

And, as was said in *Hughes v. Traherne, Admx.*, 64 Ill. 48:

"The doctrine is that a court of equity in cases of insolvency will regard the real parties in interest and allow a set-off of demands in reality mutual, although prosecuted in the name of others nominally interested."

We later cite and quote from many other cases to the same effect.

The court in *In Re United Grocery Co.*, 253 Fed. 267, wholly ignored the element of the bank's insolvency, giving rise to the equitable jurisdiction of the court in the matter of set-off, and in this it erred.

The case of *People v. California Safe Deposit & Trust*

Co., in which the circumstances were essentially identical with those in the case at bar, and the cases hereafter cited by us will, we believe, clearly disclose the fallacy of the reasoning and holding of the court *In Re United Grocery Co.*

In brief, our contention is that the insolvency of the bank has totally changed the situation, and has created a case in which, in the exercise of its unquestionable equity jurisdiction, this court should grant the relief allowed by the referee. This is also and for greater reason true, because of the additional circumstance of the solvency of the O'Gara Coal Company.

Again, in *In Re Grocery Co.*, the conclusion of the court seemed to be controlled to some extent by the fact that if the bankrupt were permitted to take credit for the amount of deposits made in the bank by the trustees, the bankrupt might thereby be enabled to get a larger ratable payment on its claim against the insolvent estate of the bank than the other creditors of the bank. This is also earnestly urged by counsel for appellant in the case at bar. This, we submit, is wholly immaterial to this court, as the cases to which we will later call the court's attention clearly and conclusively point out.

Thus see:

Scott v. Armstrong, 146 U. S. 499; 13 Sup. Ct. Rep. 148,

where this very contention was urged in the case of the liquidation of a national bank, and overruled.

See also:

Smith v. Perry, 95 S. W. (Mo.) 337.

Receivers v. Paterson Gas Light Co., 23 N. J. Law, 294.

St. Paul & Minn. Trust Co. v. Leck, 57 Minn. 87; 58 N. W. 826.

People v. California Safe Deposit & Trust Co.,
141 Pac. (Cal.) 1181.

C. D. & V. R. R. Co. v. Field, 86 Ill. 270, 272.
Porter v. Roseman, 74 N. E. (Ind.) 1105.

V.

A COURT OF BANKRUPTCY WILL EXERCISE THIS EQUITABLE JURISDICTION IN THE MATTER OF EQUITABLE SET-OFFS IN ALL CASES COMING BEFORE IT IN WHICH A COURT OF CHANCERY WOULD EXERCISE SUCH JURISDICTION.

This was clearly held in *Cumberland Glass Manufacturing Company v. DeWitt*, 237 U. S. 447; 35 Sup. Ct. Rep. 636, in which the court said:

"The matter (of set-off) is placed within the control of the bankruptcy court, which exercises its discretion in these cases *upon the general principles of equity.*"

And Chief Justice White, in elaborating upon this statement in his dissenting opinion, said:

"It is equally indisputable, as long since settled by this court, that in exercising its powers when occasion requires it, as between all or any of the items of the active or passive side of the bankrupt estate, *it is the duty of the court of bankruptcy not merely to determine the right of set-off by strict common law principles, but to govern the subject by the broad doctrines of set-off as administered by courts of equity.*"

Courts in bankruptcy or insolvency proceedings, charged with the duty and vested with the power of marshalling estates, settling the rights and interests of creditors and others therein, and making distribution of the same, have always been regarded as possessing inherent equitable power from the very nature of their jurisdiction outside of, or even in the absence of any statute.

This is clearly shown by the elaborate and well-considered case of *Receivers v. Paterson Gas Light Company*, 23 N. J. Law 283-288, to which we invite the court's special attention.

In this case the court held that the receivers of an insolvent bank are not regarded as purchasers for a valuable consideration, but take the property of the corporation in precisely the same plight and condition and subject to the same equities as they were held by the corporation, and that, in consequence, a debtor of an insolvent bank, whether his indebtedness has actually accrued or not at the time of the insolvency, may set-off against his indebtedness to the receivers, either the deposit in the bank or bills of the bank held by him at the time the bank passed into the hands of the receivers. In so holding the court, in part, said:

"It seemed to be assumed upon the argument, by the counsel, that the equitable doctrine of set-off, as applied in cases of bankruptcy, is founded upon the expressed provisions of the statutes, and it is certainly true that all modern bankrupt laws contain a provision that, in all cases where there are mutual debts or mutual credits, the balance only shall be deemed the true debt, and the rest of the claim shall be deemed adjusted by the set-off. And the fact that all well considered bankrupt laws do contain so broad a provision in favor of set-offs, is in itself the strongest authority in support of the natural equity and justice of the provision.

It is equally true, however, that the jurisdiction of equity over set-offs in cases of bankruptcy and the practice of allowing them, was not derived from the authority of the statute, but was exercised by the courts long prior to the introduction of the provision into the statute.

The general right of set-off was first introduced in the bankrupt law in the year 1708, by the statute IV Anne, cap, 17; but the course of adjusting the balance was adopted in practice as early as 1675. Thus in 28 Car. 2 (1675) Lord North said: 'If there are

accounts between two merchants and one of them becomes bankrupt, the course is not to make the other pay the whole that was originally intrusted to him, and to put him, for the recovery of what the bankrupt owes him, into the same conditions with the rest of the creditors, but to make him pay that only which appears to be due to the bankrupt on the foot of the account.' 1 Modern 215."

And again the court said (page 290) :

"The English statute authorizing set-off in bankruptcy, is not only earlier in point of time, but is broader in its provisions than the general statute of set-off. The greater extent to which the doctrine has been carried in cases of bankruptcy, is doubtless owing to the clear natural equity of the practice and the obvious injustice of compelling one of two parties, mutually indebted, to pay his entire debts, and then to receive only a dividend, with the other creditors, upon his own claim.

The same equitable principle has been uniformly applied under the insolvent laws, where the statute is silent in regard to set-off. Neither our statute abolishing imprisonment for debt nor the statute regulating the distribution of the estate of insolvents nor that respecting assignments by debtors for the benefit of creditors, contains any provision in respect to set-off, and it is clear, that in an action by an assignee under an assignment made for the benefit of creditors, there could be no set-off *at law*. Yet the uniform construction of the statute has been that the debtor of the insolvent is entitled to the same allowance by way of set-off against the claims of the assignee, that he would have been against the insolvent himself."

The same was clearly recognized and stated in *Scott v. Armstrong*, 146 U. S. 499; 13th Sup. Ct. Rep. 148.

That was a case of the insolvency of a national bank. The statute under which national banks are organized and governing their liquidation in case of insolvency makes no provision for set-off or counter-claim.

It was contended that the court in the administration

of the estate of the insolvent bank under the National Bank Laws could not recognize or allow a set-off or counter-claim, and that to do so would be against the policy of the Act and the law, in that it might give one creditor a greater payment than another and thus prevent a ratable distribution among the creditors. The Supreme Court, however, held that in the administration of the insolvent estate the equitable doctrine of set-off would be recognized and enforced, and in that connection said:

"As pointed out by counsel, the Bankruptey Act of 13 Eliz. C. 70, contained no provision in any way directing a set-off or the striking of a balance, and by its second section commissioners in bankruptey were to seize and appraise the lands, goods, money and chattels of the bankrupt, to sell the lands and chattels, 'or otherwise to order the same for true satisfaction and payment of the said creditors, that is to say, to every of the said creditors, a portion, rate and rate alike, according to the quantity of his or their debts.' 4 Statutes of the Realm, pt. I, 539. Yet, in the earliest reported decisions upon set-off it was allowed under this statute. Anonymous, 1 Modern, 215; *Curson v. African Company*, 1 Vern. 121; *Chapman v. Derby*, 2 Vern. 117.

The succeeding statutes were but in recognition, in bankruptey and otherwise, of the practice in chancery in the settlement of estates and it may be said that in the distribution of the assets of insolvents under voluntary or statutory trusts for creditors, the set-off of debts due has been universally conceded. *The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity.*"

In this connection we ask your Honors to consider the case of *In re Bell's Estate*, 141 Pac. (Cal.) 1179, which in principle and by analogy is applicable to the case at bar.

In that case a decedent was indebted to a bank at the time of his death, and, during the course of the administration of his estate, a portion of the debt was paid by the

administratrix leaving a balance unpaid. During the course of the administration of the estate, also, the administratrix deposited funds of the estate in her name in the bank, and thereafter the bank became insolvent and a receiver was appointed. The receiver thereupon filed a petition in the Probate Court for an order to require the administratrix to pay the balance of the debt due the bank from the estate, and the administratrix, in answer to this petition, set up the fact of the deposits by her as administratrix in the bank in excess of the balance due the bank from the estate, and asked that such deposits be set off against such balance, and that it be adjudged that at the date of the bank's insolvency there was owing from the bank to the administratrix a balance of \$5,200.

This application of the administratrix was denied by the Probate Court on the ground "that the court sitting in a probate matter had no jurisdiction to entertain the counter-claim or set-off pleaded by the said administratrix in her amended answer"; and, therefore, ordered that the balance unpaid to the bank be paid by the administratrix out of the funds of the estate in her hands.

On the appeal of the administratrix, the Supreme Court of California held that the Probate Court had the inherent equitable jurisdiction to entertain the defense of set-off interposed, and in so holding, the court said:

"Now, as to the question of jurisdiction. We are satisfied that the Superior Court, sitting in probate, had jurisdiction to entertain the defense of set-off interposed by the administratrix. It had jurisdiction of the estate of Bell and over all proceedings therein which included a determination of whether the bank was entitled to the order for payment of its allowed claim. It had jurisdiction of the parties in that particular proceeding and over the subject matter. It is true that the Superior Court, sitting in probate, is limited in its jurisdiction to the extent that it must

follow the mode of procedure provided by statute in the administration of the estate of a decedent, and can only determine those questions or matters arising in the estate which it is authorized to do. Here the question whether a creditor is or is not entitled to an order for payment of his allowed claim arose in the proceeding in the administration of the estate. It was a controversy arising in the estate itself, and involved the right of the creditor to share in its assets, and was a question which the court, sitting in probate, was authorized to determine. The fact that acting in probate. It may be called upon to apply legal or equitable rules or principles in considering a question it is called upon to determine does not affect its jurisdiction to do so. The Superior Court sitting in probate, is a court of general jurisdiction, and in determining any question arising in the administration of an estate which it is expressly authorized to decide, it may bring to its aid the full equitable and legal powers, with which, as the Superior Court, it is invested."

This was manifestly held to be true on identically the same principle that courts of bankruptcy or other courts having power to administer and distribute bankrupt or insolvent estates possess this power.

And as we later point out, the Supreme Court of California in another branch of this litigation arising between the same parties and involving the same matter in the bank's receivership proceeding expressly held that the administratrix was entitled to the set-off claimed by her.

See *People v. California Safe Deposit & Trust Company*, 141 Pac. (Cal.) 1181.

VI.

COURTS OF EQUITY EXERCISE A JURISDICTION IN MATTERS OF SET-OFF INDEPENDENT OF THE STATUTES ON THE SUBJECT.

See 34 Cye. 633, for a general statement of the proposition.

In *Scott v. Armstrong*, 146 U. S. 499, 13 Sup. Ct. Rep. 148, the court said:

"The right to assert set-off at law is of statutory creation, but courts of equity from a very early day were accustomed to grant relief in that regard independently as well as in aid of statutes upon the subject."

See also :

North Chicago Rolling Mills Co. v. St. Louis Ore Co., 14 Sup. Ct. Rep. 715.

Lindsay v. Jackson, 2 Paige's Chan. (N. Y.) 580.

Receivers v. Paterson Gas Light Co., 23 N. J. Law 283.

Smith v. Perry, 95 S. W. (Mo.) 337.

Eigenman v. Clark, 51 N. E. (Ind.) 725, p. 726.

Blake v. Langdon, 47 Am. Dec. 701, p. 705, 19, Vt. 485.

Richardson v. Doty, 62 N. W. (Neb.) 254.

Jeffries v. Evans, 43 Am. Dec. 158, 6 B Monroe (Ky.) 119.

VII.

A PARTY WHO FILES A CLAIM AS A CREDITOR IN A BANKRUPTCY PROCEEDING SUBMITS TO THE JURISDICTION OF THE COURT ALL QUESTIONS AS TO THE RIGHT OF SET-OFF IN BEHALF OF THE BANKRUPT ESTATE AGAINST SUCH CLAIM.

In re Harper, 175 Fed. 412-424.

In this case the creditor filed his claim, which was practically admitted to be correct. Thereafter the trustee asserted a counter-claim or set-off in the nature of an unliquidated claim for damages growing out of false and fraudulent representations made by the creditor to the bankrupt, and also growing out of a breach of contract on the part of the creditor with the bankrupt.

It was first objected that this set-off could not be allowed, because it was an unliquidated claim for damages.

The court held that such a claim came within the scope of Section 68, as a debt due from the creditor to the bankrupt.

The court also held (pp. 425-426) that the creditor "having come into this court with its claim, it is either made a party to the bankruptcy proceeding here, or has instituted a proceeding in bankruptcy—probably the latter—and hence must submit to the liquidation of the claim for damages as a set-off."

The court also said (p. 426) :

"If such a claim for damages is not regarded as the subject of off-set within the meaning of Section 68a, the trustee here must go to a foreign state and bring suit, and take his chances of making collection in case of recovery.

In either case the claimant company is in this court seeking a dividend from the estate, and it seems clear to me that under the general policy and to answer the true purpose of the law, the claim of the trustee is to

be regarded and treated as an alleged debt of that company to the estate in bankruptcy, and, if established, off-set or counter-claimed. There is no legal or equitable principle upon which it can be held that the creditor shall pay such claims for damages in full, if established, for the benefit of the estate, taking his percentage thereof by way of dividend on his claim when, if such claim for damages had been reduced to judgment against him prior to bankruptcy, he would be entitled to wipe it out in whole or in part by off-setting his claims against the bankrupt under Section 68a."

This was clearly an exercise of the equitable jurisdiction of the court, since at law such unliquidated claims cannot be set off, although they can be in equity.

In re Siegel-Hillman Dry Goods Co., 111 Fed., at page 986, the court said:

"The ruling in this case justifies the holding that in cases wherein a court of equity is charged with the distribution of an estate or a fund under its control and has before it the several parties whose rights and interests are involved in the administration of the estate, it may, *disregarding mere matters of form, but having regard to the substantial rights of all the parties*, ascertain the ultimate relation and liability of the several parties, and base its decree thereon, thus avoiding the delay and expense which would be caused if the parties were remitted to the pursuit of their legal rights without aid from a court of equity. Cases in bankruptcy, such as that now before the court, are peculiarly within this rule, and call for the exercise of the full powers of the court for the ascertainment and proper enforcement of the equities of the parties, for in no other proceeding can these equities be so well determined and protected as in the bankruptcy proceedings wherein the court is called upon to enforce the provisions of the act, which provisions largely control the rights of the parties."

VIII.

IT IS A RULE UNIVERSALLY RECOGNIZED AND APPLIED THAT THE INSOLVENCY OF THE PARTY AGAINST WHOM THE SET-OFF IS SOUGHT GIVES RISE TO THE EQUITABLE INTERVENTION OF A COURT OF CHANCERY, AND EQUITABLE SET-OFF WILL BE ALLOWED, EVEN THOUGH NOT ALLOWABLE AT LAW OR UNDER THE STATUTES.

IN SUCH CASES A WANT OF MUTUALITY, OR THE FACT THAT THE CLAIM SOUGHT TO BE SET-OFF IS UNLIQUIDATED, OR THAT THE PARTIES ARE SUING IN DIFFERENT CAPACITIES, THE REAL INTERESTS, HOWEVER, BEING THE SAME, AND OTHER OBJECTIONS PREVENTING THE SET-OFF AT LAW WILL NOT PREVENT AN EQUITABLE SET-OFF.

On page 638 of 34 Cye. it is said:

"The insolvency of the party against whom the set-off is claimed is, as a broad general rule, held to be such a special equity as will induce a court of equity to take jurisdiction to allow the set-off."

On page 717 it is said:

*"While the general rule is stated to be that a claim cannot be set off if it is in favor of or against a third person not a party to the action, other cases qualify the rule and hold that by the term 'parties' is meant not merely the nominal plaintiff and defendant, but the real parties in interest, and that the court will go outside of the record to find the real party; and thus it is very generally held that a claim against the party having the real beneficial interest in the cause sued on, although not a party to the record, may be set-off or counter-claimed, and in cases where a judgment ought not to be obtained against plaintiff for the excess over the debt sued on, so much of the set-off is allowed as will extinguish the claim. Thus in a suit by a trustee, defendant may set off a debt due him from the *cestui que trust*, and, conversely, in an action against a *cestui que trust*, he may set off a claim, the legal title to which is in the trustee, and a third party for whose benefit a simple contract has been entered into for a valuable consideration may plead it by way of set-off."*

On page 724 it is said:

"But it is held as a general rule that in equity, as at law, the right of set-off is reciprocal, and only mutual claims and such as are in the same right can be set off. But this doctrine of mutuality is not permitted to work an injustice, for whenever it is necessary to effect a clear equity or to prevent an irremediable injustice the set-off will be allowed, in equity, although the debts are not mutual and the set-off, therefore, one which a court of law would not be authorized to make, and equity, disregarding the form, and looking to the substance of a transaction, may allow a set-off although not between the nominal parties, but between the real parties in interest, and thus in reality mutual, although not nominally so, if equity demands the set-off. Thus upon a showing of insolvency, equity will set off a debt without regard to strict mutuality or whether the debts are due on the same right, and in cases of joint credit given on account of individual indebtedness or where the joint debt is a mere security for the separate debt of the principal, the equity is obvious, and a set-off will be allowed, and, although the general rule in equity, as at law, is that joint and separate debts cannot be set off against each other, wherever it is necessary to effect a clear equity, or to prevent irremediable injustice, the set-off or joint and separate debts will be allowed, and, upon proof of insolvency, a joint debt may be set off against a several debt, and conversely."

Thus in *North Chicago Rolling Mills Company v. St. Louis Ore Company*, 14 Sup. Ct. Rep. 710-716, the court said:

"By the decided weight of authority, it is settled that the insolvency of the party against whom the set-off is claimed is a sufficient ground for equitable interference."

And the court accordingly further said that although at law an unliquidated claim cannot be set off, yet

"cross demands and counter-claims, whether arising out of the same or wholly disconnected transactions

and whether liquidated or unliquidated may be enforced by way of set-off whenever the circumstances are such as to warrant the interference of equity to prevent wrong and injustice."

And again:

"The adjustment of demands by counter-claim or set-off, rather than by independent suit, is favored and encouraged by the law to avoid circuituity of action and injustice."

And so, in *Central Appalachian Company v. Buchanan*, 90 Fed. 454, Mr. Justice Lurton, after an exhaustive review of the authorities, says, on page 461:

"Neither would it seem is the equitable right of set-off limited to credits strictly mutual, if insolvency exists."

North Chicago Rolling Mill Company v. St. Louis Ore & Steel Co., 152 U. S. 596, 14 Sup. Ct. Rep. 710.

"That the claim of the appellant, the Central Appalachian Company, is unliquidated is no objection in a court of equity if insolvency exists. Under such circumstances the court will restrain the enforcement of the demand against which the set-off is to be applied until the cross-demand can be liquidated. (Citing authorities.)

A very concise and complete statement of the rule is found in *Brewer v. Norcross*, 17 N. J. Eq. 219-225, as follows:

"The general rule in equity as well as at law is, that joint and separate debts, or debts accruing in different rights cannot be set-off against each other. At law, under the statutes of set-offs, the rule is inflexible; but in equity, special circumstances give rise to exceptions. Courts of equity exercise a jurisdiction in matters of set-off independent of the statute upon the subject. *They look beyond the form of the contract to its real character; and beyond the nominal parties to the parties to be affected by the decree.* Wherever it is necessary to affect clear equity, or to

prevent irreparable injustice, the set-off will be allowed *though the debts are not mutual.*"

And the court points out that insolvency of the party against whom the set-off is claimed gives rise to the equitable jurisdiction stated.

In the case of *Hughes v. Trahern, Administratrix*, 64 Ill. 48, the court says on page 52:

"The text writers on the authority of the adjudged cases concur in stating the general rule to be, in equity as well as at law, that joint and separate debts cannot be set off against each other—that is, the courts will not allow a set-off of debts accruing in different rights. It is well settled, however, that there are exceptional cases to this general rule. From an early period in the history of our law, it seems to have been conceded that special circumstances may occur creating an equity which would justify the interference of a court of equity when a court of law could afford no relief in matters of set-off. (Citing cases.)

At law, there can be no set-off except as to mutual debts between parties to the record, *but the doctrine is that a court of equity in cases of insolvency will regard the real parties in interest and allow a set-off of demands in reality mutual although prosecuted in the name of others nominally interested.*"

And so in *C. D. & V. R. R. Co. v. Field*, 86 Ill., page 270, the court said, on page 272:

"There is a natural equity that cross-demands should be off-set against each other; and that the balance only should be recovered; and the court of chancery recognizes this principle and acts upon it in cases where the law cannot give a remedy and a separate suit in consequence of the insolvency of one of the parties.

Appellant has a legal advantage here in having a judgment, which it can collect without allowance of set-off, and which it is proceeding unfairly and unconsciously to enforce the collection of against the judgment debtors, whilst owing them a larger debt due, upon which it refuses to have the judgment ap-

plied, and which is uncollectible by suit, on account of appellant's insolvency. Equity will interfere and restrain the use of such an advantage. (Citing authorities.) *The occurring insolvency of the railroad company subsequent to the judgment affords ground for the exercise of the equitable jurisdiction here invoked."*

To the same effect is *Hahn v. Gates*, 102 Ill. App. 385, where the court says on page 387:

"When the law cannot give an adequate or complete remedy a court of chancery will act and give relief. This principle has been applied in equity where a person against whom a set-off is claimed is insolvent."

The same doctrine is stated and enforced in the case of *Quick v. Lemon*, 105 Ill., page 578, where the court says on page 586:

"But it is a natural equity that cross-demands should be set-off against each other and that the balance only should be recovered, and where the law cannot give a remedy in a separate action courts of chancery may grant relief.

The insolvency of the party against whom equitable set-off is claimed has been held sufficient grounds for the exercise of equitable jurisdiction."

To the same effect is *Engs v. Matson*, 11 Ill. App. 639; *Ehrat v. Marrone*, 191 Ill. App. 121.

In the well considered case of *Lindsay v. Jackson*, 2 Paige's Ch. (N. Y.) 580, the court laid down the same doctrine stated above, and said:

"The complainant ought not to be left to pursue his legal remedy against his defendants when from their insolvency no satisfaction of his demand could be thus obtained."

In *Porter v. Roseman*, 74 N. E. (Ind.) 1105, it was said:

"It is insisted by appellee's counsel that, conceding the validity of appellant's demand against appellee, there can be no set-off, because there is no such

mutuality as is required by Section 351 of the statutes. As applied to statutory actions, the force of the contention would be admitted, but since appellant rests his answer not upon the statutes, but wholly upon the broad principles of equity, his right must be determined within the limits of that jurisdiction. It is recognized by the courts of this, and perhaps all other American states, that a court of equity will take cognizance of cross-claims between litigants, though *wholly disconnected and wanting in mutuality* and set-off one against the other whenever it becomes necessary to effect a clear equity or prevent irremediable injustice. (Citing cases.)

Barbour, in his Law of Set-Off, page 190, says:

'If a court finds a case of natural equity, not within the statute, it will permit an equitable set-off, if, from the nature of the claim, or from the situation of the parties, it is impossible to obtain justice by a cross-section.'"

After pointing out that insolvency and non-residence give rise to this special equity, the court said:

"*In enforcing an equitable set-off the court proceeds upon the principle that one demand is, pro tanto a satisfaction of the other, and that the real indebtedness is merely the balance.*

It is said in *Forbes v. Cooper, supra*:

'*It is certainly unconscientious for an insolvent party to coerce the payment of his claim when he is owing the other party an equal or larger sum and thus leave the latter remediless.'*"

So, in *Smith v. Perry*, 98 S. W. (Mo.) 337, where mutuality was lacking, the same doctrine was laid down in a case of insolvency where the court held that where the estate of the *cestui que trust* was insolvent, the trustee's estate, in an action for an accounting, brought by the administrator of the estate of the insolvent, *cestui que trust* against the trustee, was entitled to set-off in equity certain claims held by the trustees *individually* against the *cestui que trust*.

In this case it was also squarely held that the mere fact

that thereby the trustee would be paid in full, while the other creditors of the *cestui que trust* would only be paid in part, which is the principal contention of counsel for appellant in the case at bar, did not prevent the operation of the rule, saying:

"Plaintiff urges that injustice would be done to other creditors of Lewis' insolvent estate by allowing the Perry estate to establish its counter-claims and thus virtually collect the claim in full, whereas other creditors would only receive a dividend, but the better reasoning seems to be that no injustice is done other creditors by allowing the adjustment of all accounts as they stood at the death, assignment, or *bankruptcy of the insolvent.*"

To the same effect is *St. Paul & Minnesota Trust Company v. Leck*, 57 Minn. 87; 58 N. W. 826.

So, *Dubrucil v. Gaither*, 56 Atl. (Md.) 965, where the same doctrine was laid down. A partnership had its note discounted by a bank, the proceeds being deposited therein in the name of one of the partners as trustee, for convenience only, the deposit being owned by the partnership. After the bank and the firm became insolvent, the trustee for the partners obtained judgment against the receiver of the bank for the balance of the deposits. It was held in a suit by the receiver against all the partners, that the trustee of the partners was entitled to an equitable set-off of the balance due the bank on the note against the judgment.

The court said:

"Whatever may have been the legal rights of the appellant in respect to the balance of this deposit, as between him and the bank, so long as the latter was a going concern, it is apparent that the makers of the discounted note were the substantial owners of the deposit, and that the two debts were essentially mutual in their nature; and, therefore in the present suit when all of the parties to the two transactions or their representatives are before the court, and no

third party is in the way, reason and justice require that for the purposes of the liquidation of the bank's affairs the doctrine of equitable set-off should be applied to the situation, and the appellee's claim should be allowed."

In principle this is exactly the situation in the case at bar.

We ask the court particularly to examine the case of *Dale v. Cooke*, 4 Johnson's Ch. 11, where it was held that, although generally a debt arising on a contract made with an executor cannot be set off against a debt due from the testator even in equity, yet, if it had been shown that the moneys received or collected from the debt due the executor would have gone into the estate of the testator and become a part of its assets, it could have been set off against a debt from the testator and to be paid out of his estates, because in that event clearly the estate of the testator would have been the real party in interest.

The chancellor said:

"Here was an application to set-off a debt arising on a contract with an executor against a debt arising on a contract with the testator. They are not debts due to and from the same persons in the same capacity, and there is no mutuality. It would be confounding the contracts of testators with the contracts of executors.

To remove this objection it ought at least to have appeared that the lands so leased belonged to the testator at the time of his death, and that the executors had authority to lease the same, and that the rent was made assets for the payment of debts. The will ought to have been set forth or so much of it as was requisite to satisfy the court in those particulars; the ownership of the lands leased, ought also to have been stated."

While, in the case at bar, the deposit in the bank was made by the trustees of the bankrupt and therefore as

a matter of technical law the contract was between the trustees and the bank, yet it is clear that the funds deposited belonged to the bankrupt estate, and that anything paid by the receiver of the bank on account of the deposits or any set-off that may be allowed on account of the deposit against the claim of the bank against the bankrupt estate will go into and inure to the benefit of the bankrupt estate. We have, therefore, in the case at bar the exact situation suggested by the chancellor in the case cited.

We again invite the court's attention to the case of *People v. California Safe Deposit & Trust Company*, 141 Pac. (Cal.) 1181, which we consider not only directly in point but as answering every contention that may be made against the allowance of a set-off in this case.

In that case, one Bell, was indebted to the California Safe Deposit & Trust Company in the sum of forty thousand dollars. Bell died, and in May, 1893, the claim of the trust company was filed and allowed, and payments were made thereafter by the personal representatives of the decedent so that in 1907 there was a balance due of ten thousand and ninety-three dollars and forty cents principal, together with interest from 1898. The estate of the decedent had not been wound up but was still in process of administration. Thereafter in 1902, upon application to the court by the administratrix of Bell an order was entered reducing the bond and designating the California Safe Deposit & Trust Company as depository of the funds of Bell's estate. Pursuant to this order the administratrix deposited the funds of the estate with the Trust Company from time to time, and in 1907 there was a balance due the estate of \$20,200. Subsequently the California Safe Deposit & Trust Company became insolvent, and in proceedings properly initiated, a receiver was duly appointed in 1908. In 1909 under order of

court all of the claims of the decedent's estate except the claim of the trust company, were paid, and in 1911 the receiver of the insolvent trust company presented a petition in the matter of the decedent estate asking that the administratrix pay his claim in full. The administratrix answered the petition of the receiver and claimed the right to set off the amount of her deposits as administratrix against the claim allowed to the receiver in the matter of the decedent's estate, but the Probate Court refused to take jurisdiction of that matter.

The administratrix of Bell's estate now presents this intervening petition in the insolvency of the trust company and asks that the receiver be restrained from enforcing his claim in full and also prays that she be allowed to set off against the claim of the receiver the amount of the deposits of the decedent's estate with the trust company at the time of the insolvency of the trust company. A preliminary restraining order was granted, and thereafter a demurrer to the intervening petition was sustained, and the petition dismissed, from which ruling the administratrix appealed.

The Supreme Court of California reversed the ruling of the lower court, and in a very carefully reasoned and elaborate opinion holds that notwithstanding the lack of mutuality of the claims of the administratrix and the receiver of the insolvent trust company the administratrix is entitled as a matter of equity, to off-set the amount of her deposits as such administratrix on the date of the insolvency of the trust company against the claim of the trust company against the decedent.

In view of the very pertinent language of the court in answering every material objection we shall ask the court's indulgence to quote somewhat at length from the opinion of the court in this case.

On page 1183 the court says:

"Before approaching a discussion of the question on this appeal, another point urged by respondent may be preliminarily disposed of. This is that in no event could the claim of the administrator be allowed as a set-off against the trust company or bank after the latter had become insolvent; that on the insolvency of the bank its claim against the estate was an asset to be collected by the receiver and applied ratably to the payment of claims of creditors of the insolvent bank, including a pro rata payment only of the claim of the administratrix as a depositor; *that to allow the claim of the administratrix as such depositor to be set off against the claim of the insolvent bank would be to defeat this right of pro rata distribution*; that it would be an appropriation of this latter asset of the insolvent bank to the payment in full of the claim of the administratrix as a depositor and *give her claim a preference which it was not entitled over that of other depositors.*

But the authorities do not sustain this contention. It is generally held that a *receiver* occupies no better position than that which was occupied by the party for whom he acts. He takes the property and rights of the one for whom he was appointed precisely in the same condition and subject to the same equities as existed before his appointment, and a defense, good against the original party, is good against the receiver."

The court then quotes from Pomeroy's *Equitable Remedies*, Volume 1, Sections 186 and 187, and then proceeds:

"This rule applies in the case of insolvent banks so that the right of set-off is to be determined by the condition of things as they existed at the moment the bank became insolvent. (Citing Scott v. Armstrong, 146 U. S. 499; 13th Sup. Ct., Rep. 148 and many other cases.)

Within these principles the right of set-off in the matter at bar is to be determined as of the time when the bank was adjudged insolvent, and, if that right was available to the respective claimants at that time, the insolvency of the bank did not defeat it."

The court then proceeds to the main question whether the administratrix of the estate of Bell could set-off her claim for money deposited with the trust company by her as administratrix against the allowed claim of the insolvent trust company based upon the liability of the decedent Bell, and states numerous objections raised by counsel for the receiver of the insolvent trust company to the allowance of the claim of set-off, the particular objections being the want of mutuality of the claims and the fact that under the California code such a set-off ought not to be allowed.

The court then proceeds on page 1184:

"There can be no question but that the general rule as to the necessity of mutuality is as asserted by respondent, and it may be conceded that in a strict sense there is no mutuality between the claims here under consideration; they are not due to and from the same parties and in the same capacity. The general rule, too, is well settled, as claimed, that, in actions by executors or administrators upon a cause of action arising to them after the death of the testator or intestate, a defendant cannot set-off a demand against the decedent existing at the time of his death. But this general rule is subject to exceptions which are applied in suits brought by executors or administrators such as above referred to, as well as in other actions.

It will be found, when cases of the character cited are examined, that where in such actions by executors or administrators, the right of set-off has been denied to the defendants, such denial is not so much based on a want of mutuality (and that ground in many of them is not assigned as the reason), but is put upon the ground that the allowance of such a set-off might disturb the just and equal distribution of the assets of the estate among its creditors in any case where it was uncertain, from the unsettled condition of the estate, whether the assets were sufficient to pay all the debts of the decedent, or, in the case of an estate which was actually insolvent, the allowance of such set-off would not only prevent a pro rata dis-

tribution among its creditors, but, on the contrary, would give the creditors claiming the benefit of a set-off an undue preference over other creditors of the estate to the extent of full payment of his claim.

When, however, by reason of the special character of an asserted set-off, it appears that in no particular can the rights of any party interested in the assets of the estate be affected by its allowance, or when the estate is solvent and able to pay all claims against it, including the allowed claim of a defendant asserting it as a set-off, the courts in the first instance do not, and in the latter should not, apply the strict rule of mutuality to prevent the allowance of set-off."

The solvency of the O'Gara Coal Company brings the case at bar within the reasoning of the court.

The court then proceeds to cite certain instances and authorities illustrative of these propositions, and then proceeds:

"We refer to these cases as showing that the rule of mutuality is not always controlling in actions by or against personal representatives of an estate which involves its assets, but that it will be departed from in cases where it appears that permitting the set-off to be interposed cannot in any respect embarrass the administration of the estate or prejudice the rights or interests of any other party interested in its assets.

We can perceive no reason why the principles of the decisions cited should not be applied to the demands here. We think it should, and that, notwithstanding the respective demands are not mutual, still, if any proceeding in the estate had been taken by the bank to collect its allowed claim prior to its insolvency, or the administrator had theretofore sued to collect the estate funds on deposit with it, the estate being solvent, the demand of one party would have been available as a set-off as against the claim of the other; that the rights of the parties in that respect were reciprocal, and, as we have said, *the insolvency of the bank did not affect the right of either to have this subsequently done.*"

The court then proceeds to illustrate the justice of this rule, and says:

"The creditor may be insolvent, and it is well settled that the insolvency of a party against whom a set-off is claimed constitutes a sufficient ground for the allowance of a set-off, not otherwise available. It may be that the demand due the administrator from the creditor constitutes the principal asset of the estate out of which to pay his claim, which, of course, would require a denial of the creditor's application until the administrator could collect the assets. The only effect of denying the right of set-off to the administrator in this situation would be to compel him to sue and enforce payment from the creditor if he was solvent, and this for the sole purpose of thereupon paying it back to him in satisfaction of his claim. This would be an idle and senseless thing to require a court to do. These are special circumstances but exist here: the bank is insolvent, and the debt owed by it to the administratrix represents all the money assets of the estate. Aside from this, however, in this matter at bar the circumstances present a situation where the rule of strict mutuality should, in consonance with obvious justice, be departed from and the set-off allowed. Here there is a solvent estate and a sole creditor of it, who is also in substantial effect its debtor. The bank is entitled to have its claim against the estate paid, but the administratrix is also entitled to have it pay its debt to her which represents assets of the estate. No injury can be worked to the creditor of the bank by permitting it, and *it is entitled to no advantage over the estate through denying it.* While the respective demands may not be strictly mutual, they are very intimately connected; the claimant in effect owes the estate and the estate owes him. Both demands have relation to funds of the estate. This presents a situation where, in the interest of clear right and justice an exception to the general rule of mutuality should be applied and the set-off allowed."

After further elaborating the court says, on page 1186:

"To deny the right of set-off under these circumstances simply for want of mutuality would be not

only unjust and oppressive towards the creditor but also an idle and absurd act."

We submit that this case involves every element that is involved in our situation. The LaSalle Street Trust & Savings Bank was designated the depository by the Federal court for the funds of the O'Gara Coal Company, Bankrupt, just as the California Safe Deposit & Trust Company was designated the depository of the funds of the estate of Bell. The La Salle Street Trust & Savings Bank had a claim against the O'Gara Coal Company arising before the bankruptcy, which is the claim now involved, just as the California Safe Deposit & Trust Company had a claim against Bell in his lifetime which was actually allowed in the Probate Court, and payments were made from time to time on this claim. The trustees of the O'Gara Coal Company after their appointment deposited funds with the La Salle Street Trust & Savings Bank prior to its insolvency, the amount of which deposits on the date of the insolvency of the La Salle Street Trust & Savings Bank constituted the claim of set-off which we now insist the trustees are entitled to, just as in the case referred to the administratrix of Bell's estate deposited funds belonging to the estate with the California Safe Deposit & Trust Company, the amount of which deposits on the date of the insolvency of that trust company constituted the claim of set-off which the court allowed in favor of the administratrix. The O'Gara Coal Company, the bankrupt, has paid in full all of its claims other than the contested ones, and it is concededly solvent to pay any other claims in full, just as in the case cited the estate of Bell was amply solvent and paid all of its claims except the claim of the California Safe Deposit & Trust Company which was being contested. And so we claim in every particular and in all of the important details, the two cases are exceptionally alike.

In the light of the very well reasoned opinion delivered by the court in this case, we feel that this court ought to adopt the same rule and allow the set-off of the trustees of the O'Gara Coal Company as an equitable set-off and unless this set-off be allowed, a serious injustice will be done.

As further illustrative of the same proposition, that courts will permit equitable set-offs, although the claim constituting the set-off may have arisen subsequent to the original claim of the creditor is the case of *McLane v. Johnson*, 9 Atl. (Vt.) 837.

In that case the complainant as administrator of a decedent's estate filed a bill against the defendant praying for the allowance of an equitable set-off. The facts appear to be these. The complainant's decedent was indebted on various notes to different parties, some of which notes were guaranteed for the decedent by the defendant. When these notes fell due demands for payment of some of the notes were made against the defendant. The defendant not having funds with which to pay, went to the complainant as administrator and asked that money of the estate be advanced to the defendant to enable him to pay these notes. The complainant as administrator pursuant to arrangement did advance money to the defendant with which to buy up the notes against the decedent's estate. The dividends to be paid thereon on the settlement of the estate to be offset against the loans made by the administrator. Thereafter, it seems that the defendant refused to permit the administrator to set-off the dividends against the amount advanced by him, and so the complainant filed this bill alleging that since the arrangement was entered into the defendant had become insolvent. The court held that a court of chancery has power to direct such a suit set-off although the right to the set-off accrued to the administrator and was never in the decedent. So, at page 839, the court said:

"The subject matter of set-off is one of the original and well established heads of equity jurisdiction. Our statutes allowing it have not taken away the jurisdiction of chancery, but have merely provided a remedy at law for the off-set of mutual claims between parties, which might always have been done in equity. At law, however, set-off can not be effected unless the demands are, in legal significance, mutual. Here the orator sues in his representative capacity, as administrator, upon a demand arising since the death of his intestate, and asks to have an off-set made of claims allowed against the estate he represents in favor of third persons, but now held by the defendant as assignee or equitable owner thereof. At law the claims held by the defendant could be enforced only in the names of the original holders. They were not allowances made to the defendant. They were never at law debts owing by the intestate to the defendant. Even if the debts had originally been payable to the defendant, they could not at law be off-set to a demand accruing to the orator in his representative capacity after the death of his intestate, for this would alter the course of the distribution of the assets, and give one creditor an advantage over the others.

But in equity the form of the indebtedness is disregarded, and an off-set may be decreed of liquidated demands held by an assignee or equitable owner, especially if he is insolvent. The defendant, in respect to the claims in question, stands in this relation; and his claims have been liquidated by the allowance of the commissioners and the judgment of the Probate Court thereon. He is compellable, therefore, to make the off-set, if the orator's case is in other respects made out."

So, in *Eigenman, et al. v. Clark, et al.*, 51 N. E. (Ind.) 725, in a suit by the assignee of a payee of a note against the maker, the court held that the maker of those notes is entitled to set-off payments made by him on a note which he had executed as surety for such payee, made after the suit was commenced, where the payee, assigned the notes executed by the maker after maturity, and was then insolvent.

The court says, on page 726:

"Counsel for appellees insist, however, that independently of the statute appellees are entitled to an equitable set-off. Courts have long recognized set-off as a natural equity. Before the statute of set-off courts of chancery acted upon the doctrine of set-off, as grounded upon the principles of natural equity."

The court then quotes from numerous cases in support of this proposition that whenever it becomes necessary to complete equity or to prevent irremediable injustice as in case of insolvency, a court will allow an equitable set-off. And then the court says on page 728:

"We think it fairly deducible from these decisions that insolvency is a distinct equitable ground of set-off outside of the statute."

Similarly in *Bibb Land-Lumber Company v. Lima Machine Works*, 30 S. E. (Ga.) 676, the court said:

"Upon the assumption that this plea (referring to the plea of set-off) set forth a demand by the defendant against the plaintiff, it was, in substance, good. *The general rule that, in order to authorize a defendant to plead a set-off, his demand against the plaintiff must have been in existence before the bringing of the latter's suit, is not applicable, when there is a valid equitable ground for allowing the defendant to plead as a set-off a demand against the plaintiff originating after the commencement of the action. Both insolvency and non-residence have been recognized by this court as constituting good grounds for equitable set-off.* (Citing authorities.)"

In the case of *In re Crystal Spring Bottling Co.*, 100 Fed. 265, the court held that under Section 68a, a trustee in bankruptcy could avail himself of a set-off that accrued to him as trustee and not to the bankrupt, saying:

"The trustee has moved to have the papers expunged because of these liabilities of the claimants to trustee, as an equitable set-off, and the motion has now been heard. The set-offs provided for in

the Bankrupt Acts are in cases of mutual debts or mutual credits between the estate of a bankrupt and of a creditor's Section 68a. *This would seem to include a liability that has accrued to a trustee which had not accrued to the bankrupt when the claim and liability are mutual. The mutuality required is the same as that of the Act of 1867.*"

In *Doane v. Walker*, 101 Ill. 628, and *Walker v. Doane*, 108 Ill. 236, the Supreme Court of Illinois held that where the rental value of premises purchased at an administrator's sale for the time during which they were wrongfully withheld from the purchaser by the widow was more than the amount due the widow on her claim for yearly dower payment, when she was insolvent, the purchaser was entitled to relief by equitable set-off.

In *Jeffries v. Evans*, 43 Am. Dec. 158 (6 B Monroe Ky.) 119, the complainant filed a bill to restrain the enforcement of a judgment against him obtained by one Evans, and prayed that he be allowed to off-set that judgment against two judgments that the plaintiff obtained against Evans. The bill alleges that Evans had assigned his judgment to the other defendants, and Evans was insolvent. The lower court dismissed the bill but the upper court reversed this decision and held that the plaintiff was entitled to relief, saying, page 159:

"The relief sought by the complainant does not depend upon our statute authorizing set-offs. That statute is applicable only to suits at law. The right to an off-set in chancery exists independent of the statute, and is controlled only by the general principles of equity. In this case the complainant was responsible for the judgment in favor of Evans, and to be relieved against such responsibility he had a right, as Evans was insolvent, to set up his claims upon him in a court of equity. It is true the judgment was against him and others; but that fact did not affect his liability, and from anything that appears in this record, he was equally entitled to relief as if the judgment had been against him alone."

Thus, it is well settled that an executor may apply a legacy to the payment of a debt due from the legatee to the estate, and this on the ground that the legatee is not entitled to receive his legacy and at the same time withhold from the estate moneys owing by him to the estate. As Waterman on Set-Off said, Par. 210, quoting from *Smith v. Kearney*, 2 Barb. Ch. 549:

"The right of an executor or administrator to retain in such cases, depends upon the principle that the legatee or distributee is not entitled to his legacy or distributive share while he retains in his own hands a part of the fund out of which that and other legacies or distributive shares ought to be paid or which were necessary to extinguish other claims on that fund. In other words, the legatee or distributee in such cases seeks to obtain a part of the fund which the distribution or letters of administration have placed in the hands of the executor or administrator to pay debts or legacies or distributive shares, while such legatee or distributee is himself debtor to the estate, and by withholding payment diminishing the fund to that extent, and it is against conscience that he should receive anything out of the fund without deducting therefrom the amount of that fund which is already in his hands as a debtor of the estate."

Thus, again in the case of *Jeff v. Wood*, 2 P. Wms. Rep. 128, it was decided that the executor was entitled to retain a legacy as against the assignee in bankruptcy or the legatee in satisfaction of a debt due from the legatee to the estate of the testator.

In principle the same is true of the case at bar. The bank received moneys belonging to the estate, and withholds the same from the estate. It would be unconscionable to permit it to be paid its debt in full out of the funds of the estate, and yet permit it to withhold from the estate funds received by it from and belonging to the estate and compel the estate to go into another court, there to receive only a portion of the fund received and withheld by the bank.

In conclusion, we submit that for the reasons herein-before stated, the order of the Circuit Court of Appeals for the Seventh Circuit should be reversed and the order of the District Court should be affirmed.

Respectfully submitted,

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